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No.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1980

GERALD R. REDDING, DOROTHY M. REDDING, THOMAS W. MOSES and ANNE M. MOSES,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For A Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

Robert N. Davies
(Counsel of Record)
Donald P. Bennett
810 Fletcher Trust Building
Indianapolis, Indiana 46204
(317) 636-4535
Attorneys for Petitioners

Baker & Daniels
810 Fletcher Trust Building
Indianapolis, Indiana 46204
Of Counsel

Central Publishing Company, Inc., Indianapolis, IN 46206

Question Presented

The Indianapolis Water Company, a publicly held company, as part of an integrated plan to "spin off" its wholly owned subsidiary, the Shorewood Corporation, distributed to its shareholders short-term rights to acquire common stock of Shorewood. Within the following month these stock rights were exercised and the Water Company distributed over 80% of the outstanding common stock of Shorewood. Thus, this case raises the question of whether the distribution by a parent corporation of more than 80% of the stock of a subsidiary corporation can qualify for tax deferral under section 355 if that distribution is effected by means of the prior distribution with respect to the stock of the parent corporation of transferable short term rights to acquire stock of the subsidiary corporation. If this type of transaction does not qualify under section 355, then the question arises as to whether the rights should be valued when they are issued or when they are exercised.

Parties Below

The caption of the case in this Court contains the names of all parties.

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petition For A Writ of Certiorari to the United States Court of Appeals for the Seventh Circuit

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on August 25, 1980.

Reports of Opinions Below

The opinion of the Court of Appeals (App. A, *infra*, pp. A-1 to A-29) has not yet been officially reported. It is

reported unofficially at 80-2 U.S. Tax Cas. ¶ 9637, and at 46 A.F.T.R.2d 80-5654, and 49 L.W. 2185 (Sept. 16, 1980). The opinion of the United States Tax Court (App. B *infra* pp. A-30 to A-56) is reported at 71 T.C. 597.

Jurisdiction of the Supreme Court

The decision of the Court of Appeals was rendered on August 25, 1980, and judgment was entered on that date (App. C. at p. 59). This petition for certiorari was filed within 90 days of the entry of judgment. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1) (1978).

Statute Involved

This case directly concerns the interpretation of section 355 of the Internal Revenue Code of 1954 (26 U.S.C. § 355) (1976) (the "1954 Code") set forth in Appendix D, *infra*, pp. pp. A-61 to A-64.

Statement of the Case

Section 355 of the 1954 Code sets forth the conditions under which the distribution of stock in a subsidiary corporation (referred to in that section as a "controlled corporation") by a parent corporation (referred to as the "distributing corporation") to its shareholders does not constitute a taxable event for the shareholder. When shareholders, who receive controlled corporation stock under the conditions set out in section 355, are not required to turn in any of their stock in the distributing corporation, the transaction is called a "spin off." The effect of section 355 is to allow a shareholder to defer recognizing any income or gain on the controlled corporation stock until he sells stock of either the distributing corporation or the controlled corporation. To qualify under section 355 a shareholder must receive "solely stock or securities" of the controlled corporation in a distribution to him "with respect to [his] stock." Section 355 also imposes other

conditions, compliance with which by Petitioners is not at issue.[1]

At all relevant times, Petitioners were shareholders of the Indianapolis Water Company (the "Water Company"). Prior to and during 1971 a wholly owned subsidiary of the Water Company, the Shorewood Corporation ("Shorewood"), owned, managed and was developing property surrounding the reservoirs used by the Water Company, and desired to develop further this waterfront realty. As a result of pressure from the Indiana Public Service Commission, which regulated the Water Company's activities, the Water Company decided to divest itself of control of Shorewood. However, Shorewood needed additional capital to proceed on its own. To meet these two objectives—divestiture and adequate capitalization of Shorewood—the following plan was implemented. On January 7, 1971, the Water Company distributed to its shareholders transferable rights to acquire more than 80% of the Shorewood stock. One right was distributed for each share of Water Company common stock outstanding. Two rights plus the payment of $5.00 were required to acquire a share of Shorewood stock.

The rights expired and became valueless if not exercised by 3:30 p.m. on January 22, 1971. As a result of this rights offering, on February 2, 1971, the Water Company distributed more than 80% of the outstanding stock of Shorewood. Petitioners exercised all of their rights and received an aggregate of 27,000 shares of Shorewood stock as a part of that distribution.

In short, the transaction at issue had the following economic effects: (1) the Water Company distributed and divested itself of more than 80% of the stock of Shorewood; (2) Shorewood received a substantial infusion of needed

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[1] Compliance with the other requirements of Section 355 was stipulated by the parties in the proceedings before the United States Tax Court.

capital for its business; (3) Petitioners contributed to the capital of Shorewood; and (4) Petitioners received a distribution of Shorewood common stock from the Water Company and nothing else.

Petitioners reported no taxable income on the transaction. The Commissioner assessed a deficiency against Mr. and Mrs. Redding alleging that they recognized income upon the *exercise* of their rights to acquire Shorewood stock. The Commissioner assessed a deficiency against Mr. and Mrs. Moses on the inconsistent theory that they recognized income upon the *receipt* of their rights. Other Water Company shareholders also received similar, inconsistent assessments. Petitioners, acting as representatives of the Water Company shareholders who were so assessed, petitioned the United States Tax Court for redeterminations of the deficiencies, invoking the jurisdiction of the Tax Court under sections 6213, 6214, and 7442 of the 1954 Code (26 U.S.C. §§ 6213, 6214 and 7442) (1970). The Tax Court, in a decision in which all but one judge concurred, held that the entire transaction qualified as a tax-free "spin off" of Shorewood under section 355 of the 1954 Code. The Tax Court viewed the issuance and exercise of the stock rights as an integrated transaction and held that the substance of the transaction was a distribution of the Shorewood stock to the Petitioners with respect to their Water Company stock.

On appeal the United States Court of Appeals for the Seventh Circuit, in a two to one decision, reversed the Tax Court. Two members of the Court of Appeals viewed the issuance of the stock rights and the subsequent Shorewood stock distribution as independent transactions. Based upon that conclusion, the majority of the Court held that the stock rights issuance was not a distribution of solely "stock or securities" of Shorewood as required by section 355(a), but rather was a distribution of property taxable as a dividend. They further concluded that the subsequent distribution of the Shorewood stock was not made to Water

Company shareholders "with respect to [their] stock," as required by section 355(a), but rather was made with respect to their rights. The majority of the Court then held that Petitioners realized and recognized dividend income in the amount of the fair market value of the stock rights on the date of receipt. One dissenting judge, voted to adopt the opinion of the Tax Court.

Reasons for Granting the Writ

I THE DECISION BELOW CONFLICTS WITH A DECISION OF THE SECOND CIRCUIT AND FURTHER CONFLICTS AMONG THE CIRCUITS ARE INEVITABLE

The tax treatment of a corporate "spin off" in which shareholders are issued rights to acquire stock of a controlled corporation but also must make a capital contribution to exercise the rights has been previously before this Court. That case was a result of litigation in a similar transaction, which began in the Tax Court and was decided in favor of the taxpayers in *Baan v. Commissioner*, 45 T.C. 71 (1965). The *Baan* case involved taxpayers who resided in two different judicial circuits and the appeal of the Tax Court decision resulted in directly opposing decisions by the Second and Ninth Circuits.[2]

The Court of Appeals for the Ninth Circuit, viewing the stock rights distribution as a distinct, taxable transaction, reversed the Tax Court in that case on the grounds that the stock rights were not "stock or securities" and, in any case, the stock was not "distributed" because the shareholders were required to pay for it.[3] The Court of Appeals for the Second Circuit, in *Commissioner v. Gordon*, 382 F.2d 499

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[2] *Baan v. Commissioner*, 45 T.C. 71 (1965), *rev'd*, 382 F.2d 485 (9th Cir. 1967), *aff'd sub nom. Commissioner v. Gordon* 382 F.2d 499 (2nd Cir. 1967), 9th Cir. *aff'd sub nom. Commissioner v. Gordon*, 2d Cir. *rev'd*, 391 U.S. 83 (1968).

[3] *Baan v. Commissioner*, 382 F.2d 485 (1967).

(1967), affirmed the Tax Court ruling. That Court recognized that the transaction at issue presented no opportunity for the taxpayers to extract earnings from a going business at capital gains rates, which was the evil section 355 was designed to prevent. The Second Circuit also held that the distribution should be viewed as an integrated or "step" transaction at the conclusion of which the taxpayers who exercised their rights held solely stock of the controlled corporation. Accordingly, the Second Circuit Court of Appeals held that the technical requirements of section 355 were satisified.

The taxpayers filed a Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit and the Commissioner filed a Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit. This Court granted certiorari to resolve the conflict between the Second and Ninth Circuits, but disposed of the case on an issue not relevant in this case.[4] The confusion and disagreement among the Courts of Appeals is continued by the decision below of the Seventh Circuit, which is in direct conflict on all points with the Second Circuit. Additional conflict among the Courts is inevitable because the Tax Court, pursuant to its decision in *Golsen v. Commissioner* 54 T.C. 742 (1970), is free to follow its previous decisions on this issue except in cases where an appeal would lie with the Seventh or the Ninth Circuit Courts of Appeal. A favorable decision by the Tax Court on behalf of a taxpayer who resides in another Circuit will simply result in another appeal by the Commissioner and a further conflict among the Circuits.

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[4] *Commissioner v. Gordon*, 391 U.S. 83 (1968). This Court decided *Gordon* on the issue of whether two distributions of subsidiary stock twenty months apart may be consolidated for the purpose of determining whether control (that is, 80%) of the subsidiary stock had been distributed.

II. THE DECISION BELOW IS INCONSISTENT WITH AN IMPORTANT DECISION OF THIS COURT

One of the established precepts of corporate taxation is the so-called "*Palmer* doctrine," the rule derived from this Court's decision in *Palmer v. Commissioner*, 302 U.S. 63 (1937). In *Palmer*, this Court stated that no income is recognized by a shareholder as a result of a distribution to him of rights to acquire stock of another corporation even if the rights have value when distributed. *Palmer*, *Id.*, 56 S. Ct. at 67. The decision of the Seventh Circuit that the Petitioners recognized income on the receipt of the rights to acquire Shorewood stock is in direct conflict with *Palmer*. The primary justification for this holding was that *Palmer* has limited, if any, validity under the 1954 Code because rights of the nature distributed to Petitioners are defined as "property" in section 317 which was a new section in the 1954 Code, and distributions of property are taxed as dividends under section 301. However, prior to the enactment of the 1954 Code and prior to the *Palmer* decision, this Court held that "property" included the right to acquire property. See *Helvering v. San Joaquin Co.*, 297 U.S. 496 (1936). Furthermore, there is no question that the Revenue Act of 1928, upon which the *Palmer* decision was based, treated distributions of property by a corporation to its shareholders as a dividend. Thus, although *Palmer* has been the subject of substantial discussion,[5] the holding in *Palmer* is fully applicable to

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[5] *See, e.g.*, Beinfest, *Corporate Separations: Stock Rights Distribution*, Tax Management Memorandum 79-22 (Oct. 22, 1979); Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer v. Commissioner*, 23 Tax L. Rev. 129 (1968); Gann, *Taxation of Stock Rights and Other Options: Another Look at the Persistence of Palmer v. Commissioner*, 1979 Duke L.J. 911 (1979); Jassy, *Dividend Treatment of Distributions of Options to Acquire Assets of the Distributing Corporation*, 34 Tax L. Rev. 607 (1979); Smith, *Rights Offerings of Portfolio Securities*, 26 Tax Lawyer 471 (1973); Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 Yale L.J. 1016 (1957); Comment, *Taxation of Stock Rights*, 51 Calif. L. Rev. 146 (1963).

cases arising under the 1954 Code. This fact was recognized by the Second Circuit in the *Gordon* decision, *supra*, 382 F.2d at 505, and by the Ninth Circuit in the *Baan* decision, *supra*, 382 F.2d at 493. Furthermore, *Palmer* has been cited as authoritative in other decisions interpreting the 1954 Code.[6]

The Tax Court in the case below and in the *Baan* case held that no gain is recognized on the receipt or exercise of stock rights. The Tax Court in *Baan* reasoned that (a) the receipt of rights was not taxable because of *Palmer* and (b) the exercise of the rights was not taxable because it resulted in the distribution of stock of a controlled corporation that satisfied the requirements of section 355. The Second Circuit in the *Gordon* case, *supra*, relied on *Palmer* as support for its holding that the stock rights were merely one step in an integrated transaction which resulted in stock of the controlled corporation.

The decision below is inconsistent with *Palmer* and with decisions of other courts that have relied on *Palmer* in analyzing transactions governed by the 1954 Code. This Court should issue a writ of certorari to determine whether the 1954 Code made *Palmer* obsolete and if not, whether it remains good law.

III. THE TAXABILITY OF THIS HIGHLY USEFUL METHOD OF CORPORATE DIVISION PRESENTS AN IMPORTANT FEDERAL LAW QUESTION THAT SHOULD BE SETTLED BY THIS COURT

Corporations frequently find it necessary or desirable to "spin off" subsidiaries. These subsidiaries, when no longer financed by the parent corporations, often need additional capital to survive and prosper. Because of their lack of a

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[6] *See Baumer v. United States*, 580 F.2d 863 (5th Cir. 1978); *Bateman v. Commissioner*, 40 T.C. 408 (1963).

separate financial history, it is difficult to raise that needed capital. A natural place to look for additional capital is to the shareholders of the parent corporation, who are familiar with the subsidiary and may have confidence in its prospects. The transaction undertaken by the Water Company is the easiest and most efficient business method for a publicly held corporation to separate a subsidiary while providing an infusion of new equity capital. The alternative of an initial spin-off of the stock of the controlled corporation itself, followed by a separate offering of additional stock by the spun-off corporation would require substantial additional expense to prepare, file and distribute two separate registration statements under the Securities Act of 1933. Except for that expense there is no economic difference to the corporations of their shareholders between the two forms of transactions. The shareholder who exercises his rights, makes the additional capital contribution, and remains a shareholder of both the parent corporation and the subsidiary corporation should not be saddled with a tax at that time, and section 355 does not impose such a tax.

It is more logical, simple, and consistent with the corporate tax scheme of section 355 to delay taxation until the stock or stock rights are sold at specific, identifiable prices.

The uncertainty with respect to the use of the issuance of stock rights as a mechanism for distribution of the stock of a subsidiary corporation substantially impedes the use of this valuable business reorganization method. Review by this Court is necessary to remove these uncertainties in this important area of the income tax laws.

Conclusion

For the above reasons, Petitioners respectfully request that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit.

Respectfully submitted,

Robert N. Davies
(Counsel of Record)
Donald P. Bennett
BAKER & DANIELS
810 Fletcher Trust Building
Indianapolis, Indiana 46204
(317) 636-4535

Counsel for Petitioners

Appendices

Appendix A

In the

United States Court of Appeals

For the Seventh Circuit

Nos. 79-1775 and 79-1776

GERALD R. REDDING and DOROTHY M. REDDING and THOMAS W. MOSES and ANNE M. MOSES,

Petitioners-Appellees,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent-Appellant.

Appeal from the Decisions of the United States Tax Court

ARGUED FEBRUARY 14, 1980—DECIDED AUGUST 25, 1980

Before BAUER, WOOD and CUDAHY, *Circuit Judges.*

CUDAHY, *Circuit Judge.* This is an appeal by the Commissioner of Internal Revenue from determinations of the United States Tax Court that Gerald R. and Dorothy M. Redding and Thomas W. and Anne M. Moses ("taxpayers") do not owe any income tax on account of the receipt or

exercise of stock warrants.[1] These warrants were distributed as part of a series of transactions involving distribution by the Indianapolis Water Company (the "Water Company") to its stockholders of all the stock of its wholly-owned subsidiary, Shorewood Corporation ("Shorewood"). The distribution of warrants was made preliminarily to the distribution of stock, which was distributed upon the exercise of the warrants. The Tax Court treated the two distributions as being part of a single transaction, sheltered from taxation under section 355 of the Internal Revenue Code of 1954,[2] granting nonrecognition to a corporation's distribution to its stockholders of stock or securities in a controlled corporation. We hold that the distribution of stock warrants to the taxpayers constituted a dividend to them and that section 355 is not available to render the transaction nontaxable. We, therefore, reverse.

I.

The Water Company, which is a public utility, owned all of the stock of Shorewood, which in turn owned most of the waterfront property surrounding the reservoirs used by the Water Company. Shorewood wished to develop its waterfront realty, but the Indiana Public Service Commission determined that real estate development was

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[1] The terms "stock rights" (or "rights") will be used in this opinion interchangeably with the term "warrants" since both terms have been used interchangeably in this litigation. In financial circles, "warrants" usually refer to *longer-term* options to purchase stock at a stated price (a "subscription price" or "exercise price" or "option price") than do stock rights. In the instant litigation some of the parties and the Tax Court have also referred frequently to stock rights evidenced by warrants. *See* Whiteside, *Income Tax Consequences of Distribution of Stock Rights to Shareholders*, 66 YALE L.J. 1016, 1016-17 n.1 (1957); J. Weston & E. Brigham, *Managerial Finance, 1018*, 1020 (6th ed. 1978).

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

not an appropriate activity for a public utility and suggested that Shorewood be separated from the Water Company.

To achieve this end, Shorewood's capital structure was altered. In 1970, Shorewood's authorized common stock was increased from 1,000 to 2,500,000 shares. On the same day, Shorewood issued to the Water Company 481,291 shares of common stock in exchange for Shorewood's 1,000 shares then outstanding and held by the Water Company. On January 6, 1971, the Water Company agreed to purchase an additional 855,630 shares of common stock from Shorewood for a total ownership of 1,336,921 shares. The board of directors of the Water Company decided to distribute to its shareholders of record on January 6, 1971, stock rights or warrants to purchase Shorewood stock on the basis of one warrant for each share of the Water Company common stock outstanding. The warrants gave the holder the right to receive one share of Shorewood stock upon surrender of two warrants and the payment of $5.00 to the Water Company and further right to subscribe to any remaining Shorewood shares by allotment. The warrants were transferable.

The total offering of Shorewood shares by the Water Company thus amounted to 1,069,537 shares, which comprised slightly more than 80% of the total outstanding amount of Shorewood stock. Of these shares to be offered, 50,000 shares were reserved for the underwriters, and 1,019,537 shares were available for distribution to warrant holders. Any shares not sold to warrant holders were to be bought by the underwriters, on a "firm commitment" basis, at a slightly discounted price. The Water Company thus retained slightly less than 20% of the outstanding Shorewood stock. Immediately after the distribution, the shareholders of the Water Company held substantially more than 50% of the outstanding shares of Shorewood.

The warrants were issued on January 7, 1971, and expired and became valueless if not exercised by 3:30 p.m.

on January 22, 1971. During this subscription period, shareholders or their transferees or assignees subscribed to all 1,069,537 Shorewood shares offered, except for 50,000 shares acquired by the underwriters. Hence, 1,019,537 shares of Shorewood stock were actually distributed to the warrant holders and 50,000 shares conveyed to the underwriters on February 2, 1971. As contemplated by the Water Company, an over-the-counter market in warrants developed during the subscription period, with the price ranging from $0.39 to $1.05 per warrant. There is no dispute that both at the time of issuance and at the time of exercise of the warrants the subscription price of $5.00 was less than the fair market value of Shorewood stock. That is to say that at all relevant times there was a "spread" between the subscription price and the fair market value of Shorewood stock.

Taxpayers were stockholders of the Water Company. Gerald and Dorothy Redding owned 7,000 Water Company shares, and Thomas and Anne Moses owned 35,543 shares. They received a corresponding number of warrants and exercised all of them. The Moseses also exercised an additional subscription privilege to obtain an additional 6,228 shares of Shorewood stock.

Taxpayers contended that both the receipt and the exercise of the warrants were tax-free to them under the provisions of section 355.[3] It was stipulated that the

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[3] Section 355 provides:

(a) Effect on distributees—

(1) General rule.—If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(Footnote continued on following page)

transaction was not a "device" for the distribution of earnings and profits pursuant to section 355(a)(1)(B);[4] that the separately conducted "active business" requirements of section 355(a)(1)(C) were met; that the 1,069,537 shares of Shorewood distributed in the offering amounted to 80% control; and that the shares retained by the Water Company were not held for tax avoidance purposes within the meaning of section 355(a)(1)(D)(ii).

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continued

> (B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),
>
> (C) the requirments of subsection (b) (relating to active businesses) are satisfied, and
>
> (D) as part of the distribution, the distributing corporation distributes—
>
> > (i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
> >
> > (ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,
>
> then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.
>
> ...
>
> (b) Requirements as to active business.—.... I.R.C. § 355.

[4] At the time of distribution the Water Company had accumulated earnings and profits in excess of $8 million. This was adequate to cover the distribution.

II.

The Tax Court[5] agreed with taxpayers that the transactions involved in these cases met the requirements for a corporate division, in this case a "spin-off," contained in section 355 and were, accordingly, tax-free. A spin-off occurs when the stock of a subsidiary corporation is distributed to the shareholders of the parent without the surrender by them of stock in the parent.[6] "[T]he general purpose of Congress in sanctioning, in proper cases, tax-free spin-offs was to permit the real owners of enterprises to rearrange their units and evidences of ownership to suit their own ideas of how best to carry on their businesses." *Commissioner v. Wilson*, 353 F.2d 184, 186 (9th Cir. 1965). *See* H. Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4019, 4059. *Accord* S. Rep. No. 1622, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4621, 4672.

In reversing the Tax Court, we find taxpayers have failed to meet their burden of showing that the several transactions here meet the tests of section 355 so as to qualify for nonrecognition of the gain otherwise subject to tax. As the parties and the Tax Court acknowledged to be the case were we to find section 355 inapplicable, we conclude the distribution of the warrants by the Water Company is taxable as a dividend. It is not controlling that

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[5] The Tax Court opinion is reported at 71 T.C. 597 (1979).

[6] "Section 355 also shelters 'split-offs' and 'split-ups.' A 'split-off' involves the same kind of transaction as a 'spin-off' except that the shareholders surrender part of their stock in the parent corporation in exchange for stock in the subsidiary. In a 'split-up,' the parent corporation transfers substantially all of its assets to two or more corporations and then liquidates, its stockholders surrendering all their stock in the transferor and receiving the stock of the transferee corporations." *Commissioner v. Baan*, 382 F.2d 485, 491 n.9 (9th Cir. 1967), *aff'd sub nom. Commissioner v. Gordon*, 391 U.S. 83 (1968). *See* B. Bittker & J. Eustice, *Federal Income Taxation of Corporations and Shareholders* ¶ 13.01 at 13-3 - 13-4 (4th ed. 1979).

taxpayers sold none of their rights, exercised all of them, and received stock for them (for which taxpayers also paid the additional consideration of $5.00 per Shorewood share). The tax treatment of taxpayers must depend upon an analysis of the transaction as a whole rather than only of the specific facts applicable to these taxpayers. This is true because the nonrecognition of gain afforded by section 355 requires adherence to requirements governing the transaction as a whole.[7]

The Tax Court, in determining whether the issuance of the warrants and their exercise by warrant holders should be immunized from tax by section 355, purported to rely heavily on its prior ruling granting tax-free status to warrants used in somewhat similar transaction in *Baan v. Commissioner*, 45 T.C. 71 (1965),[8] *rev'd*, 382 F.2d 485 (9th Cir. 1967), *aff'd sub nom. Commissioner v. Gordon*, 382 F.2d

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[7] As the Supreme Court stated in *Commissioner v. Gordon*, 391 U.S. 83, 91-94 (1968),

> Section 355 provides that certain distributions of corporations controlled by the distributing corporation do not result in recognized gain or loss to the distributee shareholders. *The requirements of the section are detailed and specific, and must be applied with precision*...Congress has abundant power to provide that *a corporation wishing to spin off a subsidiary must, however bona fide its intentions, conform the details of a distribution to a particular set of rules* (footnote omitted) (emphasis supplied).

This comment is merely a restatement of legislative intent regarding the care with which section 355 is to be administered:

> Your committee has carefully considered the application of the so-called court made rules such as the "business purpose" doctrine... It is your committee's intention, ... that *literal compliance with all the provisions upon which the statute conditions nonrecognition of gain or loss shall be sufficient to achieve the results there set forth.* H. Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4254 (emphasis supplied).

[8] "[Absent] some indication of the need for self-correction, the policy of stare decisis operates in petitioners' favor. *Helvering v. Hallock*, 309 U.S. 106 (1940)." 71 T.C. at 608.

499 (2d Cir. 1967), 9th Cir. *aff'd sub nom. Commissioner v. Gordon*, 2d Cir. *rev'd*, 391 U.S. 83 (1968).[9] In *Baan*, the Tax Court apparently felt that it could ignore the issuance of warrants as a taxable event under the dictum of *Palmer v. Commissioner*, 302 U.S. 63 (1937), that an issuance of stock rights is not a dividend,[10] and that it could proceed to consideration of the warrant *exercise* and stock issuance only.[11] In the instant case, on the other hand, the Tax Court expressly declined to state a view on the current vitality of the *Palmer* dictum.[12] Instead, it applied the "step

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[9] As is obvious from the citation of subsequent history, the *Baan* litigation spawned several opinions illuminating various facets of the instant problem. The Court of Appeals for the Ninth Circuit reversed the finding of non-taxability and the Supreme Court affirmed that judgment on grounds not addressed by the Tax Court, which are not essentially germane here.

In addition, commentary—both before and after *Baan*—has dealt extensively with a number of the issues presented here. *See, e.g.*, Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of* Palmer v. Commissioner, 23 TAX L. REV. 129 (1968); Gann, *Taxation of Stock Rights and Other Options: Another Look at the Persistence of* Palmer v. Commissioner, 1979 DUKE L.J. 911 (1979); Whiteside, *supra* note 1, 66 YALE L.J. 1016 (1957); Comment, *Taxation of Stock Rights*, 51 CALIF L. REV. 146 (1963); Note, *Taxing Corporate Distributions of Stock and Property Warrants*, 51 COL. L. REV. 496 (1951); Note, *Income Taxation—Reorganization—Exercise of Rights Received in Spin-off Held Nontaxable—Sale of Rights Taxable as Dividend*, 35 U. CINN. L. REV. 254 (1966); Note, *Corporate Tax: Spin-offs under Section 355;* Commissioner v. Baan *and* Commissioner v. Gordon, 54 VA. L. REV. 295 (1968).

[10] "The mere issue of rights to subscribe and their receipt by stockholder, is not a dividend." *Palmer v. Commissioner*, 302 U.S. at 71. *See, infra*, at 29.

[11] In *Baan*, the Commissioner had claimed that the taxpayers had received ordinary income measured by the difference between the fair market value of the distributed stock and its subscription price.

[12] "For if the rights distribution was but a step to be ignored in a section 355 transaction, we need not decide whether the rights distribution standing alone would be a taxable event or whether the *Palmer* doctrine has viability under the 1954 Code... Because we resolve this case in petitioners' favor on the section 355 issue without reliance upon the stock rights issue in *Palmer*, we do not reach the question of the *Palmer* doctrine's current vitality." 71 T.C. at 602-03 & n.4.

transaction doctrine" to reach its conclusion that the two transactions which took place should be viewed as "steps" in a single transaction meeting the requirements of section 355 and that, hence, neither the receipt nor the exercise of the warrants results in tax. We shall, therefore, address first the applicability of the step transaction doctrine, which we think is significantly related to the current status of the *Palmer* dictum, to be discussed later. As to the application of the step transaction doctrine, we believe the Tax Court erred.

III.

The attempted application of the step transaction doctrine in this case to shift the focus from the issuance of the stock rights or warrants to the subsequent distribution of stock is important, because, to qualify under section 355, a distribution must consist solely of stock or securities, which do not include stock rights such as these. *See* Treas. Reg. § 1.355-1(a) (1979). *See also* S. Rep. No. 1622, 83d Cong., 2d Sess. 266, *reprinted in* [1954] U.S. CODE CONG. & AD NEWS 4621, 4902. As the Court of Appeals for the Ninth Circuit said in *Commissioner v. Baan*,

> [Section 355(a)(1)(A)] relates "solely" to the distribution of "stock or securities" of the controlled corporation. Further, in view of section 355(a)(1)(D)(ii), which incorporates the "control" definition of section 368(c), the "stock or securities" distributed must carry voting rights. Stock rights are not stocks or securities and, most assuredly, are not stock or securities carrying voting rights. They are only options to purchase stock. 382 F.2d at 492 (footnote omitted).

See Gordon v. Commissioner, 424 F.2d 378, 381-83 (2d Cir. 1970) construing the similar language of section 354(a)(1).

The Tax Court does not disagree with the conclusion but seeks to keep the related transactions within the ambit of section 355 by integrating through the step transaction doctrine the distribution of stock warrants and the

subsequent exercise of these warrants. By that technique the overall transaction can be viewed as a distribution solely of stock, which is allegedly immunized from tax by section 355.

The commentators have attempted to synthesize from judicial decisions several tests to determine whether the step transaction doctrine is applicable to a particular set of circumstances in order to combine a series of steps into one transaction for tax purposes. Unfortunately, these tests are notably abstruse—even for such an abstruse field as tax law. And we must bear in mind, in applying the "tests" that "[t]he step transaction doctrine is only a judicial device expressing the familiar principle that in applying the income tax laws, the substance rather than the form of the transaction is controlling." Note, *supra* note 9, 51 CALIF. L. REV. at 157 (footnote omitted).

In any event, one of the tests which the parties ask us to consider is the "end result" test, whereby purportedly separate transactions will be amalgamated into a single transaction when it appears that "the successive steps where made 'in furtherance of, and for the purpose of executing and putting into effect, the plan of reorganization.'" Mintz & Paul, *supra* note 13, at 250. *See also Kuper v. Commissioner*, 533 F.2d 152, 155-56 (5th Cir. 1976), and cases cited therein. Here, the distribution of stock warrants was not made for the purpose of reaching the end result of distributing stock to the Water Company shareholders. Indeed, the workings of the stock warrant mechanism indicate that it was a matter of relative indifference to the Water Company, from the standpoint of raising capital for Shorewood or for itself, whether the Shorewood stock went to Water Company shareholders, or to their assignees of warrants (or to the underwriters). Had the paramount purpose of the Water Company been to distribute its portfolio Shorewood stock in a way that Water Company shareholders would in the end become Shorewood shareholders, the obvious way to proceed would have been simply to omit the first "step" and to distribute Shorewood stock directly to Water Company shareholders. But such ar

approach would have made it difficult to raise new capital, which was a paramount and somewhat inconsistent goal.

We find unexpected support for our conclusion in the Tax Court's finding that,

> The issuance of the rights by Water Co. shareholders was merely a *procedural device* to give Water Co. shareholders the opportunity to be *included* or *excluded* from the Shorewood stock distribution by their own decision. These rights existed only for a short period of time and only for this very limited purpose. Thus, their distribution was merely a brief transitory phase of a *corporate separation.* 71 T.C. 610-11 (emphasis supplied).

The transferable quality of the warrants demonstrates that they were not intended primarily to facilitate the *inclusion* of Water Company shareholders in the Shorewood stock distribution. No transferable warrants would have been required to *include* these Water Company shareholders. In fact, if the sole purpose of the transactions were to give Water Company stockholders a direct interest in Shorewood (the ostensible purpose of a corporate division), transferable warrants would not have been necessary. Instead, a direct stock distribution would have sufficed. Here, where the Water Company's purpose went far beyond a simple corporate division, the use of transferable warrants made it possible to bring in *new* distributees for the Shorewood stock (together with new capital for Shorewood and for Water Company). Therefore, the reason for using transferable warrants was to arrange in advance for Water Company shareholders to be excluded as recipients of Shorewood stock in favor of new investors prepared to make a capital contribution.[13] Hence, to the

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[13] The exclusion of Water Company investors was, of course, at their own option and was made attractive to them by their opportunity to sell the warrants at a profit to other investors willing to provide capital. Whether the payment by the warrant holders for stock is called the "sales price" of the stock or a "capital contribution" is not crucial to our analysis. *Compare Commissioner v. Baan*, 382 F.2d at 492, *with Commissioner v. Gordon*, 382 F.2d at 504-05, 505-06. *See* Note, *supra* note 9, 54 VA. L. REV. at 307-10.

extent that the rights distribution was a step, it was not a necessary step in the sort of corporate division contemplated by section 355.[14] Our conclusion is directly buttressed by the stipulation of the parties that "[t]he use of rights that required payment of a subscription price as a method of distribution of the Shorewood common stock was dictated by the need of Shorewood for capital to develop its assets and business." Stipulation of Facts at ¶ 22, Brief for Appellees, Supplemental Appendix A.

The reference of the Tax Court to the warrant issue as a "merely procedural device" is misleading.[15] Insofar as the warrants had a readily ascertainable market value, they had independent economic significance, and, as indicated, their function in the series of transactions was to make it possible for Water Company shareholders to defer profitably to others who were prepared to make an investment in Shorewood. Further, since the warrant distribution had independent economic significance, that distribution was a matter of substance rising above mere form or procedure.

Taxpayers also contend that it was not essential to use warrants as evidence of "legal rights" to receive stock and

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[14] "[The] purpose [of section 355] and the purpose of its predecessors is to give to stockholders in a corporation controlled by them the privilege of separating or 'spinning off' from their corporation a part of its assets and activities and lodging the separated part in another corporation which is controlled by the same stockholders. Since, after the spin-off the real owners of the assets are the same persons who owned them before, Congress has been willing that these owners should be allowed, without penalty, to have their real ownership divided into smaller . . . entities than the single original corporation, if the real owners decide that such a division would be desirable." *Commissioner v. Wilson*, 353 F.2d at 186

[15] The use of warrants (options) might be a "merely procedural device" *if* the subscription price was the same as fair market value, and there was no "spread." These conditions do not pertain here. *See* Gann, *supra* note 9, at 962.

that this fact is significant. They describe several alternative procedures not involving the issuance of warrants which would have provided the same "legal benefits or opportunities" as those provided by warrants.[16] As a result, they say the fact that the legal rights to receive stock were "evidenced by a piece of paper" did not break "the connection between the distribution of rights to acquire Shorewood stock and the actual distribution of the Shorewood stock." In conclusion, they argue:

> [T]he mere fact that the rights of the Taxpayers and other shareholders were evidenced by transferable warrants did not provide them with any legal benefits or opportunities they would not have had in a *more typical section 355 spin-off.* Brief for Appellees at 21 (emphasis supplied).

But simply because some other means (which arguably comply with section 355) might have been used to reach ultimate results similar to those sought in this case does not

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[16] As one hypothetical procedure, they suggest the board of directors could have simply resolved on January 7, 1971, that on February 2, 1971, the Water Company would distribute to its shareholders of record on January 6, 1971, one share of newly issued Shorewood stock for each two shares of Water Company stock. Under these circumstances, following taxpayers' argument, the shareholders of the Water Company on January 6, 1971, would have had the legal right to receive the Shorewood stock on February 2, 1971. These shareholders could then have sold the stock which they had a legal right to receive on a "when-issued" basis to new purchasers. On February 2, the existing stockholders would receive the distributed shares but would be legally obligated to retransfer those shares to the new purchasers. Alternatively, taxpayers could have sold their Water Company shares before February 2, on the ex-dividend basis, meaning the taxpayer would have retained the right to receive Shorewood stock but would have sold his Water Company stock to a new purchaser. Any Water Company shareholder who sold his stock ex-dividend would not have been a Water Company shareholder on the date he received Shorewood stock.

The record does not disclose the practicability of these procedures, particulary if the need to raise $5.00 per Shorewood share is introduced into the problem.

suggest that the procedures followed here are entitled to section 355 treatment.

First, "'[t]he Commissioner is justified in determining the tax effects of transactions on the basis in which taxpayers have molded them.' *Television Industries, Inc. v. C.F.R.*, 284 F.2d 322, 325 (2d Cir. 1960)." *Commissioner v. Gordon*, 382 F.2d at 514 (Friendly, J., dissenting). Second, taxpayers do not explain precisely how the suggested alternative means would raise capital (a paramount objective). Third, Congress narrowly constrained the means for gaining the tax benefit; the issue here is whether the means of using transferable warrants comply with the "detailed and specific requirements of section 355." *Commissioner v. Gordon*, 391 U.S. at 92. Fourth, the fact that the rights were "evidenced by a piece of paper" gave them a marketable identity and helped endow them and their receipt with independent economic significance.[17]

The second "test" for determining whether the step transaction doctrine applies is the so-called "interdependence test," which requires an evaluation "whether on a reasonable interpretation of objective facts the steps are so interdependent that the legal relations created by one transaction would have been fruitless without a completion of the series." Paul & Zimet, *Step Transactions*, in Paul, SELECTED STUDIES IN FEDERAL TAXATION (2d series 1938) 200, 254. *See also King Enterprises, Inc. v. United States*, 418 F.2d 511, 516 (Ct. Cl. 1969), and cases cited therein; 3 Mertens, LAW OF FEDERAL INCOME TAXATION (Rev. 1972), § 20.161. Although there is some question whether the "interdependence test" is even relevant to the corporate division situation,[18] were we to apply the test to the facts

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[17] "[T]he rights themselves are valuable items of property freely traded on the market." Gann, *supra* note 9, at 974.

[18] *See King Enterprises, Inc. v. United States*, 418 F.2d at 518 n.8, *quoting* a discussion to that effect in the context of certain types of reorganizations in Mintz and Plumb, *Step Transactions in Corporate Reorganizations*, 12 N.Y.U. INST. ON FED. TAX. 247, 285 (1954).

before us we would not find use of the warrants sufficiently indispensable to achieving a spin-off to compel us to view this as a unitary transaction. *See ACF-Brill Motors Company*, 14 T.C. 263 (1950), *aff'd*, 189 F.2d 704 (3d Cir. 1951). While the exercise of the warrants here was obviously dependent upon warrants having been issued, the issuance of warrants did not require their exercise by shareholders in the purchase of stock from the Water Company. The Water Company would have divested itself of Shorewood stock and raised money *without* exercise of the warrants by shareholders. Insofar as the issuance of warrants contemplated the raising of capital through the disposition of stock, the result would have been essentially the same whether the warrants were exercised by Water Company shareholders or by non-shareholder assignees. Even if the warrants were not exercised at all, the underwriters had agreed to purchase the stock (albeit at a slightly reduced price). Although the use of warrants made it more likely than a public offering that Water Company shareholders would end up as Shorewood shareholders, the money would have come in and the stock gone out with or without the exercise of the warrants. On the other hand, the transferable warrants led away from, rather than toward, a goal of spinning off to *shareholders*, which could have occurred by direct stock distribution without warrants. Considering the Water Company's diverse purposes, there is little evidence that it acted in concert with its shareholders who exercised warrants to achieve a joint objective.

Finally, the Commissioner argues that the transactions before us also fail to satisfy a third test permitted invocation of the step transaction doctrine, the "binding commitment" test. As explained by the Supreme Court in *Commissioner v. Gordon*, 391 U.S. at 96, the step transaction doctrine should not apply unless "if one transaction is to be characterized as a 'first step' there must be a binding commitment to take the later steps." The Commissioner, noting that the Tax Court in the instant case

found that there was no binding commitment for a stock distribution to follow the rights issuance,[19] stresses that the absence of such commitment renders the step transaction doctrine inapplicable. Although this is a valid contribution to the analysis, we do not find the point determinative.

The Supreme Court articulated the binding commitment test in the factual context of a multi-step distribution similar to that before us. Given this similarity, we would embrace and apply the "binding commitment" test were it not for one important difference between the *Gordon* case and that before us. The multi-step distribution in *Gordon* took place in successive tax years, a time-span obviously exceeding the several weeks involved in the instant case. This lengthly time period raised the possibility that the transactions' tax impact would remain indefinite and indeterminable for an unlimited period, an eventuality inconsistent with the premise of annual tax accounting and one the Court may have thought necessitated the "binding commitment" test. We cannot say that the Court intended that the failure to satisfy the test in the circumstance of a much shorter period would automatically preclude application of the step transaction doctrine. Hence, the lack of "binding commitment" is simply one factor to which we give appropriate consideration here. Certainly, it is not necessary for us to rely on this factor to reach our result.

Our examination of the facts in light of the various tests convinces us that the issuance of transferable warrants not only had independent economic significance but added nothing to the essential process of effecting a spin-off, "to permit the real owners of enterprises to arrange their units and evidences of ownership to suit their own ideas of how best to carry on their business." *Commissioner v. Wilson*, 353 F.2d at 186. It may be, as the Tax Court emphasizes, that the warrants were in existence for only a short period of time but their economic value is clear, and they were

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[19] *See* 71 at T.C. at 610.

actively traded during the period of their existence. Fundamentally, we think it inappropriate to substitute the step transaction doctrine as a tax shield for the warrant issuance if the dictum of *Palmer v. Commissioner* is no longer available to immunize the warrant transaction. *See, infra*, at 29-35.

IV.

Even were we to agree that the step transaction doctrine permits these transactions to be viewed as simply a distribution of Shorewood stock, the requirement of section 355(a)(1)(A) that this stock be distributed *with respect to* the stock of the Water Company has not been met. What has instead happened has been that the stock warrants have been distributed with respect to the stock of the Water Company, and the Shorewood stock has then been distributed with respect to the warrants (as well as to the underwriters). It was the warrant distribution rather than the stock distribution which conformed to this statutory test.

After the distribution of warrants to Water Company stockholders had taken place, the subsequent distribution of shares of Shorewood stock was made "with respect to" the holders of warrants—some Water Company shareholders and some not—and to the underwriters. This was not, in the words of the Supreme Court, "conform[ing] the details of a distribution to a particular set of rules." *Commissioner v. Gordon*, 391 U.S. at 94.[20] As Judge Sterrett said in dissent in the Tax Court,

> How can it be claimed that the exchange, between Water Co. and a nonshareholder third party, of Shorewood shares in return for $5 and two warrants, was "actually" a distribution to a distributing

[20] On precisely this point, Judge Friendly said, "Certainly the words [of the statute] have an uneasy fit to the transaction . . . in question." *Commissioner v. Gordon*, 382 F.2d at 513 (Friendly, J., dissenting).

corporation shareholder with respect to his stock? 71 T.C. at 616.

It has been argued that the status of the Water Company shareholders was important because their existence created any purchaser's right to receive the stock "through" the stockholders of the Water Company, as the Tax Court suggested in the comparable situation of *Baan v. Commissioner*, 45 T.C. 71. But, in comparison with the more straightforward view that section 355 contemplates simply distributions to shareholders, this analysis is painfully strained. The Tax Court was apparently not unduly troubled by the problem of distributions to non-stockholders or the fact that the use of transferable warrants structured the transaction in the direction of transfers to third parties. The Tax Court was apparently satisfied by the fact that the shareholders of the Water Company actually received more than 50% of the Shorewood stock, a sufficient percentage to satisfy the so-called continuity-of-shareholder-interest test.

The continuity-of-shareholder-interest test is "a doctrine of judicial origin based on what is conceived to be the unstated but fundamental statutory purpose of providing for nonrecognition of gain or loss only if the reorganization exchange is distinguishable from a sale...." B. Bittker and J. Eustice, *supra* note 6, ¶ 3.05 at 3-19. Generally, if one-half or more of the stock remains in the hands of the original shareholders, such continuity of interest is adequate proof that a sale was not effected. Here, the Tax Court found it harmless from the standpoint of fulfilling the "with respect to its stock" requirement of section 355(a)(1)(A) that Shorewood stock was sold to third parties so long as 50% or more of it ended up with Water Company shareholders. The Tax Court apparently reasoned (although this is not explicit in its opinion) that when section 355 applied to a rights offering, it was enough, for purposes of section 355(a)(1)(A) that at least 50% of the stock or securities of the

subsidiary come to rest in the hands of shareholders of the parent.[21]

This way of thinking conflicts with that of the Court of Appeals for the Ninth Circuit which stated in *Commissioner v. Baan*, "Congress could well conclude that the prospect that the same people (shareholders of the distributing company) will continue to own the same business would be undermined if a distribution was effectuated by means of transferable stock rights, the exercise of which required substantial cash payments." 382 F.2d at 495. We cannot agree with the Tax Court, if we understand its reasoning, that the failure of the distribution of Shorewood stock to be "with respect to" Water Company stock was harmless merely because 50% or more of Shorewood stock came to rest with Water Company shareholders. We know of no authority that mere satisfaction of the 50% standard is enough to meet the section 355(a)(1)(A) problem.[22]

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[21] The comments of the Tax Court on these points are somewhat cryptic. For our interpretation of them, *see* Gann, *supra* note 9, at 977.

[22] In addition, because of the requirements of section 355(a)(1)(B), set out in full at note 3 *supra*, the 50% standard is presumably applicable where there has been no prearrangement of stock transfers to third parties after the distribution. In the instant circumstances, a distribution of stock *based on a prior distribution of rights*, where some of the rights are sold before the stock is distributed, is a situation where "stock...[is] sold...pursuant to an arrangement...agreed upon prior to...[the] distribution [of the stock]." I.R.C. § 355(a)(1)(B). Any such transfer by pre-arrangement to non-stockholders might render the transaction at least presumptively nonconforming under section 355. *See Gann, supra* note 9, at 975 n. 161, 964 n.145; B. Bittker and J. Eustice, *supra* note 6, at ¶ 14.11. We are, of course, aware of the stipulation here with respect to section 355(a)(1)(B), but, in divining the intent of Congress, we think all the subsections of section 355 must be read together to arrive at the meaning, for example, of section 355(a)(1)(A).

V.

We reach only in passing the further issue upon which Judge Sterrett relied in his dissenting opinion below that the Water Company did not distribute 80% of the Shorewood stock within the meaning of section 355(a)(1)(D), and therefore that the transaction was not tax-free under section 355. The Tax Court found that this issue was foreclosed by the stipulations entered into by the parties for purposes of this litigation.

Section 355(a)(1)(D) requires that stock constituting "control" of the controlled corporation, defined under section 368(c) as at least 80%, must be distributed. We think the "distribution" referred to in section 355(a)(1)(D) is the same "distribution" as that referred to in section 355(a)(1)(A) requiring a "distribution" to shareholders of the issuing corporation with respect to its stock. In other words the statute "requires distribution of control to *shareholders of the distributing corporation.*" *Redding v. Commissioner*, 71 T.C. at 617 (Sterrett, J., dissenting).

Here, after the transaction at issue, the Water Company retained 267,384 shares or exactly 20%, less one share, of the total 1,336,921 shares of Shorewood stock issued and outstanding. The Water Company thus must have distributed slightly more than 80%. But of the shares constituting this 80%, 50,000 were acquired by the underwriters. As Judge Sterrett found, the transfer of the 50,000 shares to the underwriters reduced the percentage of the stock "distributed" to Water Company shareholders to, at most, 76.26% of all Shorewood shares issued.[23] Were it

[23] We do not know to what level this figure was further reduced by the exercise of warrants by individuals who received or purchased them from Water Company shareholders.

We find somewhat persuasive the reasoning applied by Judge Sterrett in concluding his analysis of the section 355(a)(1)(D) issue:

> In order to sustain the Court's decision herein one would have not only to ignore the substance and importance of the rights issuance,

(Footnote continued on following page)

not for the stipulation, we would probably be persuaded by the Commissioner on this point, and the issue would necessarily be significant in our decision.

VI.

Given our conclusion that the step transaction doctrine does not require this transaction to be seen simply as a distribution of Shorewood stock and our further finding that even if it could be so viewed, there has been a failure to comply with the requirements of section 355, we must turn finally to a determination of what constitutes the taxable event.

The Commissioner contends that the taxable event is the receipt of the warrants; taxpayers contend that, if the transaction is taxable at all, the taxable event would be the exercise of the warrants. There is also a difference of view as to how to measure the income received with respect to the warrants. In our view these matters are rather simply dealt with under the Internal Revenue Code of 1954.

The method of taxing corporate distributions was extensively revised in the 1954 Code. A distribution to shareholders, as such, of rights to acquire stock of the distributing corporation is, with exceptions not germane here, excluded from gross income under section 305. Rights distributed to shareholders to acquire the stock of another corporation, however, are *not* specifically excluded from gross income by the 1954 Code.

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but also assume that all [the recipients of] the rights traded over the counter and all the underwriters were also Water Co. shareholders. I cannot join in this assumption and it seems, in any event, to be contrary to the . . .[statutory] language. The petitioner has not shown to whom Water Co. transferred "control" inasmuch as no one related group of distributees had 80 percent of Shorewood's stock immediately after the transfer. It is not this Court's function to assume petitioners' prima facie case. Rather, such case must be proven. 71 T.C. at 617 (Sterrett, J., dissenting).

Section 301(a) of the Code states that, except as otherwise provided in chapter 1 of the Code, a distribution of property, as defined in section 317(a), made by a corporation to a shareholder with respect to its stock, will be treated as provided in section 301(c). Section 301(c) provides that where section 301(a) applies to a distribution, that amount of the distribution that is a dividend, as defined in section 316, will be included in gross income.

Under section 316(a), any distribution of "property" by a corporation to its shareholders out of its earnings and profits accumulated after February 28, 1913, is a "dividend." "Property" as defined in section 317(a) "means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or right to acquire such stock)." The specific *exclusion* of rights to acquire stock of the distributing company implies that rights to acquire stock of another corporation are *included* in the term "property." Indeed, the legislative history of the 1954 Code leaves no doubt that this broad definition of property includes stock warrants:

> As a result of [the exclusion in] this definition, the receipt of stock, of a corporation which is not stock of the distributing corporation (or is not treated as such stock under...section 353 [later renumbered as section 355]...) would be treated as property for the purpose of section 301 (and other relevant provisions of this sebsection). H. Rep. No. 1337, 83d Cong., 2nd Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4238.

See also Baumer v. United States, 580 F.2d 863, 881 (5th Cir. 1978); Rev. Rul. 70-521, 1970-2 C.B. 72; Carlson, *supra*, 23 Tax. L. Rev. at 141.

Thus, since the distribution of warrants here was not sheltered from taxation by section 355, taxpayers received a dividend upon receipt of the warrants and the amount of the dividends was the fair market value of the warrants received. *See* Rev. Rul. 70-521, 1970-2 C.B. 72.

VII.

It is argued, of course, that such a result contradicts the dictum of *Palmer v. Commissioner*. In that opinion Mr. Justice Stone said:

> The mere issue of rights to subscribe and their receipt by stockholders, is not a dividend. No distribution of corporate assets or diminution of the net worth of the corporation results in any practical sense. Even though the rights have a market or exchange value, they are not dividends within the statutory definition...[citations omitted] They are at most options or continuing offers, potential sources of income to the stockholders through sale or the exercise of their rights. Taxable income might result from their sale, but distribution of the corporate property could take place only on their exercise. 302 U.S. at 71.

But this analysis in the *Palmer* dictum was made under the Revenue Act of 1928, which did not contain the broad definition of "property" added in 1954 as section 317(a) of the Code.[24] Obviously, the Internal Revenue Code of 1954 must govern our decision. Although the superseding legislation and the congressional commentary it generated did not specifically discuss the *Palmer* dictum, several provisions of the 1954 Code governing corporate distributions seem incompatible with the principle that income never results from the mere issuance of stock rights. Whether, in enacting these provisions, Congress intended to "overrule" *Palmer* with respect to its famous dictum is left for us to intuit. We believe, though, that a "reasonable interpretation" of the corporate distribution provisions as a whole yields the conclusion that even if the

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[24] As has been noted, "[T]he 1928 revenue statute,... defined a dividend as 'any distribution made by a corporation to its shareholders, whether in money or in other property, out of its earnings and profits.' The *Palmer* Court concluded that the issuance of an option did not constitute a distribution out of corporate profits, and so was not a dividend." Gann, *supra* note 9, at 940.

dictum was authoritative prior to 1954, it must now make way for a result consonant with the 1954 Code (and, incidentally, more reflective of economic reality).[25]

In addition to the definition of "property" in section 317(a), which we find includes stock rights in the shares of a non-issuing corporation, the 1954 Code added a provision in section 305 which indicates another change in the law of tax-free receipt of stock rights. The general rule of section 305(a) excludes from taxability stock rights to acquire stock in the issuing corporation. However, one exception to this rule in section 305(b) is designed to tax distributions when they are effectively granted "in lieu of money." If the exception applies, the distribution of stock or of stock rights "shall be treated as a distribution of property to which section 301 applies." This exception precludes any inference that Congress intended to perpetuate the *Palmer* dictum. Thus, both sections 305(b) and 317(a) vitiate the "no property" rationale of the *Palmer* dictum. *See* Whiteside, *supra* note 1, at 1029-30; Comment, *supra* note 9, 51 CALIF. L. REV. at 150-51.

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[25] Our conclusion is supported by the presumption employed in statutory interpretation that "legislative lanugage will be interpreted on the assumption that the legislature was aware of...judicial decisions that [hold] if a change occurs in the legislative language a change was intended in legislative result...." C. Sands, 2A Sutherland Statutory Construction, § 45.12 at 37 (4th ed. 1973). In fact, the drafters of the 1954 Code demonstrated their awareness of this presumption when they stated with specific reference to amendments affecting corporate distributions and adjustments,

> [Y]our committee's bill is considerably more detailed than the existing code. As a result of the complexity of the transactions involved, stautory brevity is to a large extent incompatible with clarity in this area. However, *by codifying numerous judicial and administrative decisions and by replacing many others by clear statutory provisions* your committee's bill represents a real simplification of existing law. H. Rep. No. 1337, 83d Cong., 2d Sess., *reprinted in* [1954] U.S. CODE CONG. & AD. NEWS 4017, 4058 (emphasis supplied).

Indeed, the Supreme Court itself has apparently done the next thing to explicitly rejecting the *Palmer* dictum in light of the 1954 Code. In *Commissioner v. Gordon*, the Court discussed the relevant provisions of the Code and said that when a corporation sells its property to its stockholders or their assignees at less than fair market value, the transaction diminishes the net worth of the corporation and is a "distribution of property" within section 316. In attempting to relate this statement to discussion of the same subject in *Palmer*, the Court made broader observations:

> In *Palmer*, rights were distributed entitling shareholders to purchase from the corporation shares of stock in another corporation. Finding that the sales price represented the reasonable value of the shares at the time the corporation committed itself to sell them, the Court found no dividend. It held that the mere issue of rights was not a dividend. *It has not, however, been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or the dividend occurs on the actual purchase.* 391 U.S. at 90 n.4 (emphasis supplied).

This statement in *Gordon*, which as we have noted was quite similar on its facts to the instant case, withdraws any compulsion which may previously have arisen from the dictum in *Palmer* to prohibit treating the receipt of stock rights as the receipt of a dividend. In the instant case, the Tax Court pointedly refused to assess the *Palmer* doctrine's current vitality. 71 T.C. at 603 n.4. Further, in *Baumer v. United States*, the Court of Appeals for the Fifth Circuit, confronted with a problem similar to ours, carefully limited the *holding* in *Palmer* to its precise facts. 580 F.2d at 878-81.[26] We think the better interpretation under the

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[26] "[T]he Fifth Circuit in *Baumer* limited the application of *Palmer* to a situation in which no spread exists on the date of issuance and the option period is so short that it is contemplated that the property

(Footnote continued on following page)

provisions of the 1954 Code and the regulations construing them is that, in the case of stock rights, where the subscription price is lower than fair market value, there is a dividend at the time of issuance (and receipt) of the rights measured by the fair market value of the rights at the time of issuance.

This conclusion is buttressed by repeated commentary since enactment of the 1954 Code. The commentators have not restricted their attacks on the continued vitality of the *Palmer* dictum to discussions of the incompatibility of the 1954 amendments and *Palmer's* no-property rationale:

> Not only is the statutory language [of the 1954 Code] inconsistent with the view that the nature of stock rights prevents the shareholder from receiving a taxable interest upon issuance, it also seems to repudiate the judicial requirements [expressed in *Palmer*] of corporate intention to make a distribution. The statute now provides a simpler and more objective test—has the corporation in fact made a distribution of property to the shareholders under section 301? "Distribution," not expressly defined, is used in context to describe an actual transfer of property by the corporation to the shareholders, and, as already seen, stock rights in shares of...another corporation are embraced within the statutory pattern. Whiteside, *supra* note 1, at 1030-31.

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continued

subject to the option will be immediately sold to the shareholder before any substantial appreciation in the value of the underlying property can occur. Under the *Baumer* opinion, the issuance of the option is the distribution of a valuable asset to be taxed as a dividend if a spread exists on the date the option is issued, or if no spread exists on the date of issuance, but the option period is long enough so that the corporation contemplates appreciation. This analysis looks at the economic effect of the transaction to determine the existence of a dividend, and it correctly encompasses the two factors that attribute value to options—that is, both the existence of a spread on the date of issuance, and the length of the option period and potential appreciation during that period." *Gann, supra* note 9, at 956-57.

Furthermore,

> [T]he *Palmer* theory seems inconsistent with current views about the nature of options to buy stock and of the nature of dividends. To say that rights are "merely" an offer for a sale does not really go to the heart of the question. A transferable right to buy stock ordinarily has real economic value—even if the price is at or above current value. This is proved simply by the fact that such rights can be sold. The receipt of stock rights that can be sold for value is well within the limits to which the concept of income has now been pushed....
>
> To say that a distribution of rights to buy portfolio shares cannot be a dividend because it results in no diminution of corporate assets is in any event not a complete legal argument. In the first place, a corporation that has granted an option on its property has in a real economic sense parted with a valuable asset—the right to dispose of that property to others and thus to realize any spread between its market value and the option price—not to mention the sacrifice of its interest in any future increment in value while the option is outstanding. But more to the point, there is no rule that a dividend must diminish corporate assets, although that is usually its effect. Carlson, *supra* note 9, at 152-53.

We believe that we are required under the provisions of the 1954 Code to move beyond the dictum of *Palmer* and its pre-1954 progeny such as *Choate v. Commissioner*, 129 F.2d 684 (2d Cir. 1942).[27] A fair reading of the decision of the

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[27] *Choate* established that whether or not a distribution of stock rights is taxable as a dividend is to be determined by an objective assessment of whether the corporation intended to make a distribution of earnings. That intent hinges on the existence of a spread between the option price and the fair market value of the property on the date of issuance of the rights. If such an intent is found to exist, the rights will be taxed at exercise upon the lesser or either the spread on the date of issuance or on the date of exercise.

Supreme Court in *Commissioner v. Gordon* requires that *Palmer* be limited to its facts, namely, a situation where there was no spread between option (subscription) price and market value on the date the corporation adopted its plan of distribution. When a substantial spread between market and option price prevails at all relevant times, we perceive no requirement to follow rigidly the *Palmer* dictum. Since options (warrants) are "property" as defined in the 1954 Code, they fall easily within the scope of the statutory scheme for the taxation of dividends. Such an approach better reflects economic reality since an option incorporating a spread is a thing of value capable of being actively traded in public markets. Further, from an administrative point of view the valuation approach dictated by the Code and regulations seems simpler than that developed in valuation cases purportedly based on *Palmer*, such as *Choate, Gibson v. Commissioner*, 133 F.2d 308 (2d Cir.), *cert. denied*, 320 U.S. 805 (1943), and *W.G. Maguire & Co. v. Commissioner*, 20 T.C. 20 (1953).[28] Hence, based on careful analysis of relevant authority and a perception of the economic realities, we believe that the step we take here is fully justified. The time has come to put *Palmer* in perspective, and we do so with full confidence that our conclusion meets the most exacting standards of deference to the precedents of the Supreme Court, which in all respects control the decisions of the inferior federal courts. *See Hendricks County Electric Membership Corp. v. N.L.R.B.*, No. 80-1283 (7th Cir. July 21, 1980).

REVERSED and REMANDED for further proceedings consistent with this opinion.

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[28] For a discussion of the complications which give rise to problems of administrative complexity, *see* Gann, *supra* note 9, at 937-38.

BAURER, *Circuit Judge, dissenting.* I dissent. I would adopt the opinion of the Tax Court and affirm its judgement.

A true Copy:
Teste:

Clerk of the United Court of Appeals for the Seventh Circuit

Appendix B

UNITED STATES TAX COURT

GERALD R. REDDING AND DOROTHY M. REDDING, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

THOMAS W. MOSES AND ANNE M. MOSES, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket Nos. 5174-75, 5176-75.Filed January 22, 1979.

Petitioners were stockholders in Water Co. On Jan. 7, 1971, they received from Water Co. stock subscription rights, evidenced by transferable warrants, entitling them to purchase stock in Shorewood, a wholly owned subsidiary of Water Co., for less than its fair market value. The subscription period expired on Jan. 22, 1971, after which time the rights and warrants were totally worthless. Petitioners exercised their rights during the subscription period, and after tendering their rights and the requisite cash consideration, on Feb. 2, 1971, the date of the stock distribution, received shares of Shorewood stock. *Held:* Viewing the transaction as a whole, Water Co. distributed "solely stock or securities" of a controlled corporation to petitioners-shareholders "with respect to its stock" as part of a transaction in which it "distributed" over 80-percent control of Shorewood within the meaning of subparas. (A) and (D) of sec. 355(a)(1), I.R.C. 1954. The other requirements of sec. 355 having been satisfied, no amount is includable in the incomes of petitioners as a result of either their receipt or exercise of their stock subscription rights.

Robert N. Davies, for the petitioners.
Thomas L. Kummer, for the respondent.

OPINION

BRUCE, *Judge*: Respondent determined deficiences in the Federal income taxes of petitioners for the calendar year 1971 as follows:

Docket No.	*Petitioners*	*Deficiency*
5174-75	Gerald R. Redding and Dorothy M. Redding.....	[1]$3,397.91
5176-75	Thomas W. Moses and Anne M. Moses.....	10,655.39

These consolidated cases raise two significant and complex issues concerning the taxability of corporate distributions. The threshold question is whether petitioners received taxable dividend income as a result of either their receipt or exercise of rights issued to them by the Indianapolis Water Co. (Water Co.) to acquire stock in its wholly owned subsidiary, the Shorewood Corp. (Shorewood), for less than its fair market value. Resolution of this question depends upon (1) whether, if the rights distribution and stock distribution to petitioners are viewed as an integrated whole for tax purposes, the overall transaction satisfies the requirements of section 355,[2] and if so, (2) whether the rights distribution to petitioners is to be accorded independent tax significance or is but a step in an integrated transaction, which step is to be ignored for tax purposes. In the event the transaction is not governed by section 355, we must determine the proper measure of the tax, *i.e.*, whether it is the rights distribution or the exercise of the rights which triggers the dividend provisions of the 1954 Code. The amount of gain realized by petitioner Thomas W. Moses upon his sale of 8,000 shares of Shorewood stock is also at issue herein, but resolution of that dispute has been treated by the parties as entirely dependent upon our determination of the principal questions.

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[1] Respondent concedes on brief that the sole adjustment in his notice of deficiency which increased the taxable income of petitioners Redding overstated the proper amount of such increase. Consequently, if the issue providing the basis for respondent's adjustment is decided in accordance with his position on brief, a computation under Rule 155 will nevertheless be necessary in docket No. 5174-75.

[2] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1954, as amended.

The facts have been fully stipulated by the parties, and, with one exception (see n. 3 *infra*), we adopt them as our findings.

Petitioners Gerald W. and Dorothy M. Redding and petitioners Thomas W. and Anne M. Moses are respectively husbands and wives with their legal residences in Indianapolis, Ind. Each timely filed joint Federal income tax returns for the calendar year 1971 with the Office of the Internal Revenue Service at Memphis, Tenn.

Water Co., an Indiana corporation organized in 1881, is a public utility engaged in the distribution and sale of water throughout Indianapolis, Ind. Shorewood is an Indiana corporation organized on November 7, 1960, primarily for the purposes of acquiring, operating, developing, and selling certain real estate, initially, at least, certain property originally acquired by Water Co. incident to its acquisition of land for water supply reservoirs. Since 1964 and through the present time, each corporation has engaged in the active conduct of its own trade or business.

From the date of its incorporation until December 24, 1970, Shorewood had 1,000 shares of common stock outstanding, all of which were owned by Water Co. On December 24, 1970, Shorewood's authorized common stock was increased from 1,000 shares with a par value of $100 per share to 2,500,000 shares with a par value of $1 per share. The same day, Shorewood issued 481,291 shares of the $1 par value common stock to Water Co. in exchange for the 1,000 shares of $100 par value common stock then outstanding. On January 6, 1971, Shorewood and Water Co. entered into a stock purchase agreement for the acquisition by Water Co. of 855,630 additional shares of Shorewood common stock. At no time prior to or during 1971 did Shorewood have shares of stock outstanding other than shares of its common stock.

On January 7, 1971, Water Co. distributed, with respect to its stock, to its shareholders of record at the close of

business on January 6, 1971, rights, evidenced by transferable warrants, to acquire an aggregate of 1,069,537 shares of Shorewood common stock. The aggregate shares offered were comprised of the 855,630 shares to be acquired by Water Co. pursuant to the January 6 agreement with Shorewood and 213,907 shares of the 481,291 Shorewood shares already held by Water Co. Each Water Co. shareholder received one right for each share of common stock held by him.

Each right distributed by Water Co. consisted of (1) a primary subscription right to subscribe for 1 share of Shorewood common stock upon the surrender to two rights plus the subscription price of $5, and (2) an additional subscription privilege to subscribe at the same subscription price of $5 per share to all shares not subscribed for pursuant to excercise of the primary subscription rights, subject to allotment and to the right of the underwriters, under certain conditions, to purchase up to 50,000 shares (at the subscription price less minimum commissions). The subscription offer expired at 3:30 p.m. on January 22, 1971, and thereafter the rights and warrants were totally worthless.

During the subscription period, Water Co. shareholders or their transferees or assignees subscribed to all 1,069,537 Shorewood shares offered, except for 50,000 shares acquired by the underwriters. The 1,069,537 Shorewood shares distributed by Water Co. on Feburary 2, 1971, constituted more than 80 percent of the total number of shares of the only class of Shorewood stock outstanding and represented control of Shorewood as defined in section 368(c). Immediately after the distribution, Water Co. continued to own 267,384 Shorewood shares, and Water Co. shareholders held substantially more than 50 percent of the Shorewood stock outstanding. Water Co. shareholders have continued to maintain continuity of interest in Shorewood, and Water Co.'s retention of Shorewood shares was not pursuant to a plan having as one of its purposes the avoidance of Federal income tax.

The reason for Water Co.'s distribution of Shorewood stock was adverse criticism from the Indiana Public Service Commission. Water Co.'s retained control of Shorewood's real estate business was thought to be incompatible with Water Co.'s public utility business. The use of the rights that required payment of a subscription price as the method of distributing Shorewood stock was dictated by Shorewood's need for capital to develop its assets and business. The distribution was not used as a device for distributing Water Co.'s earnings and profits, of which it had accumulated as of January 7, 1971, in excess of $8 million.

The distribution by Water Co. to its shareholders or their assignees consisted exclusively of the rights to acquire Shorewood stock and the 1,069,537 shares which were subsequently distributed upon the exercise of those rights.

The rights were traded over the counter during the subscription period, and the following are representative transactions:

Date	*Number rights sold*	*Selling price per right*	*Total*
1/11/71	2,960	$0.625	$1,850.00
	900	0.6306	567.50
1/12/71	1,290	0.44	567.60
	2,926	0.4928	1,441.93
1/13/71	15,180	0.45	6,831.00
1/14/71	1,200	0.5253	630.36
1/15/71	13,924	0.4815	6,704.42
1/18/71	15,268	0.44	6,717.92
1/19/71	10,988	0.3903	4,288.61
1/20/71	4,766	0.5271	2,512.16
1/21/71	4,682	0.955	4,471.42
1/22/71	850	0.5271	448.04
	8,142	1.0647	8,668.78

The fair market value of Shorewood stock on selected-dates during the subscription period was as follows:

Date	*Fair market value*
Jan. 7, 1971	$6.20
Jan. 11, 1971	6.20
Jan. 12, 1971	6.00
Jan. 13, 1971	6.00
Jan. 18, 1971	5.70
Jan. 20, 1971	6.60
Jan. 21, 1971	7.00

Petitioners Redding and petitioners Moses were Water Co. shareholders of record on January 6, 1971, and in accordance with their stock holdings, on January 7, 1971, the Reddings received 7,000 rights and the Moseses received 35,543 rights.[3] The Reddings exercised their 7,000 rights on January 12, 1971, and, after tendering those rights and $17,500, they received 3,500 shares of Shorewood common stock on February 2, 1971, the date of the stock distribution. On January 21, 1971, the Moseses exercised their 35,543 rights. The same day, in addition to exercise of the primary subscription rights, petitioner Thomas W. Moses exercised his additional subscription privilege to acquire another 6,228 Shorewood shares. However, 4,000 of these latter shares were acquired in an agency capacity for A.E. Rosenberg, who received the shares and gave petitioner Thomas W. Moses a $20,000 note. Consequently, on February 2, 1971, petitioners Moses received 20,000 shares of Shorewood common stock pursuant to exercise of the rights they received as Water Co. shareholders. Neither the Reddings nor the Moseses reported any income from their receipt or exercise of the rights to acquire Shorewood common stock for less than its fair market value.

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[3] Apparently as the result of a typographical error, the parties stipulated that Thomas W. and Anne M. Moses received a total of 34,542 stock subscription rights rather than the correct number of 35,543.

Respondent's primary contention is that the rights distribution on January 7, 1971, was a taxable dividend. In this regard he seeks a judicial stamp of approval on Rev. Rul. 70-521, 1970-2 C.B. 72, wherein he ruled that the distribution by a corporation to its shareholders of short-term transferable rights to acquire stock in another corporation is taxable under section 301. He would tax petitioners here on the fair market value, as of the date of distribution, of the rights that they received to acquire Shorewood stock. On this record he would attribute no particular tax consequences to the February 2, 1971, stock distribution.

Petitioners' primary argument, on the other hand, focuses on the Shorewood stock distribution. They maintain that the rights distribution was but one step in a plan to effectuate the corporate separation of Shorewood from Water Co., an integrated transaction qualifying under section 355, such that no amount is includable in their incomes. They concede that unless the two steps are considered together as an integrated transaction which meets the requirements of section 355, they realized taxable dividend income. Petitioners disagree with respondent's theory for taxation of the dividend, however. They contend that if section 355 is not applicable to them, under *Palmer v. Commissioner*, 302 U.S. 63 (1937), and *Choate v. Commissioner*, 129 F.2d 684 (2d Cir. 1942), they realized income only upon the exercise of their rights, and the amount of that income is the lesser of the difference between the subscription price paid and the fair market value of the shares of Shorewood stock they received on either (1) the date the rights were issued, or (2) the date their rights were exercised.

Though the parties differ on the rudiments of taxing rights to acquire portfolio stock, the threshold question is whether petitioners' participation in the corporate separation of Shorewood from Water Co. was within the terms of section 355. For if the rights distribution was but a

step to be ignored in a section 355 transaction, we need not decide whether the rights distribution standing alone would be a taxable event or whether the *Palmer* doctrine has viability under the 1954 Code.[4]

Section 355[5] provides that certain distributions of stock or securities of a corporation controlled by the distributing

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[4] Respondent dismisses petitioners' reliance upon the *Palmer* doctrine with the brief statement that the case of *Palmer v. Commissioner*, 302 U.S. 63 (1937), is inapplicable "since it dealt with rights to purchase assets of a corporation for their full fair market value." Respondent is quite correct in his perception of the facts involved in *Palmer*, but the school of thought based upon certain dicta in that case (*i.e.*, the *Palmer* doctrine) is not limited by the fair market value distinction. See D. Carlson, "Taxation of 'Taxable' Stock Rights: The Strange Persistence of *Palmer v. Commissioner*," 23 Tax L. Rev. 129 (1968); F. Whiteside, "Income Tax Consequences of Distributions of Stock Rights to Shareholders," 66 Yale L. J. 1016 (1957). Because we resolve this case in petitioners' favor on the sec. 355 issue without reliance upon the stock rights issue in *Palmer*, we do not reach the question of the *Palmer* doctrine's current vitality.

[5] SEC. 355. DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—

(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation"—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(Footnote continued on following page)

corporation do not result in recognizable gain or loss to, or any amount includable in the income of, recipient shareholders or security holders. The conditions under

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continued

(C) the requirements of subsection (b) (relating to active businesses) are satisified, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(Footnote continued on following page)

which the general rule is applicable are set forth in subparagraphs (A) through (D) of subsection (a)(1) and elaborated upon in the other provisions of the statute. The

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continued

(4) CROSS REFERENCE.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only be reason of transactions in which gain or loss was not recognized in whole or in part, or only be reason of such transactions combined with acquisitions before the beginning of such period.

parties have by stipulations and concessions narrowed our inquiry in this case considerably. They agree that Water Co.'s distribution of Shorewood stock was not a transaction used principally as a device for the distribution of the earnings and profits of either corporation, the requirement imposed by subparagraph (B), and that the active business requirements referred to in subparagraph (C) were satisfied. Likewise, for purposes of subparagraph (D), it is stipulated that the 1,069,537 Shorewood shares distributed on February 2, 1971, was an amount of stock constituting control within the meaning of section 368(c), and that Water Co.'s retention of certain Shorewood shares was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax. Furthermore, there was a valid business purpose for both the corporate separation and the particular method by which it was carried out, and Water Co. shareholders have continued to maintain a continuity of interest in Shorewood after the separation. See sec. 1.355-2(c), Income Tax Regs. Finally, there is no question but that petitioners were shareholders in the distributing corporation, that Shorewood was a controlled corporation, and that as part of the corporate separation petitioners received no property other than rights to acquire Shorewood stock, and upon exercise of their rights, shares of Shorewood stock.

The parties' point of departure is centered around the restrictions of subparagraph (A) that only stock or securities of a controlled corporation that are distributed to a shareholder with respect to the stock of the parent are entitled to be received without inclusion in income. In statutory terms, the questions argued on brief are (1) whether petitioners received "solely stock or securities" of Shorewood, and if so, (2) whether Water Co. distributed the Shorewood stock to petitioners "with respect to its stock."[6]

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[6] Though we ultimately resolve the question in favor of petitioners, our use of the word "distribute" and its derivatives throughout the opinion should not be taken as a prejudgment of the issue.

Respondent has attempted to raise an alternative argument in his reply brief that the "distributes" requirement of subparagraph (D) has not been satisfied if the transaction is found to be part sale and part distribution. Although we do not ordinarily consider issues raised for the first time on brief, inasmuch as we would be unable to give effect to a stipulation to an erroneous conclusion of law (*Littauer, et al., Executors v. Commissioner*, 25 B.T.A. 21, 28 (1931)), and because no facts not in evidence are necessary to decide the issue (*Anderson v. Commissioner*, 156 F.2d 591 (2d Cir. 1946)), we could treat the question of compliance with subparagraph (D) as being properly before us. However, the item which is, and should be, in issue is compliance with *Code* section 355(a)(1)(A). In fact respondent, also in his reply brief, "readily admits that if the Indianapolis Water Co. satisfied the requirements of Code section 355(a)(1)(A), the petitioners are entitled to treat the dividends they received as tax free." The stipulation of facts has settled the questions of compliance with the "device" restrictions of subparagraph (B), with the "active business" requirement of subparagraph (C), and with the "control" requirements of subparagraph (D). The mere use of the word "distributes" in subparagraph (D) was not intended to be any different from the use of that word in subparagraph (A). S. Rept. 1622, to accompany H.R. 8300 (Pub. L. 591), 83d Cong., 2d Sess. 266 (1954). Fulfillment of the "distributes" requirement in subparagraph (A) would satisfy that requirement of subparagraph (D) as well. Further, failure of Water Co. to satisfy subparagraph (A) would dispose of petitioners' claim. Therefore, we need not and will not separately consider the "distributes" language relative to subparagraph (D).

Whether a distributing corporation's use of stock rights allowing its shareholders to purchase stock in a controlled subsidiary at less than its fair market value can satisfy the requirements of section 355(a)(1)(A) has been litigated only

once before. In *Baan v. Commissioner*, 45 T.C. 71 (1965), the taxpayers were stockholders in Pacific Telephone & Telegraph Co. (Pacific) and in that capacity received transferable short-term rights to acquire stock in Pacific Northwest Bell Telephone Co. (Northwest), a wholly owned subsidiary of Pacific. In order to acquire a single share of Northwest stock, it was necessary to surrender six rights and pay $16 in cash. The Northwest stock had a value substantially in excess of the $16 subscription price, both on the date the rights were issued and on the date the taxpayers exercised their rights. The Commissioner determined deficiencies based on the taxpayers' having received dividend income equal to the spread between the $16 subscription price and the value of the Northwest shares on the date the rights were exercised, the spread being lower at that time than on the date the rights were issued. (See *Baan v. Commissioner;* 45 T.C. at 87 n. 4.) The taxpayers argued that the transaction was completely tax free under section 355. We agreed with the taxpayers, holding inter alia, that the Northwest stock, rather than the rights, was the subject of the distribution within the meaning of section 355(a)(1)(A), and that the intercession of the stock rights scheme did not prevent the distribution of Northwest stock to them from being "with respect to" their ownership of stock in Pacific.[7]

Baan was a consolidated proceeding in this Court involving two taxpayers. The Commissioner appealed our decisions to the Courts of Appeals for the Second and Ninth Circuits.[8] In affirming our decision sub nom. *Commissioner v. Gordon*, 382 F.2d 499 (2d Cir. 1967), the Second Circuit held that the distribution of Northwest stock was the

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[7] We also rejected the Commissioner's contention that Pacific did not "distribute" the Northwest stock as required by sec. 355(a)(1)(D).

[8] Each step in the *Baan* litigation involved issues not presented in this case. Our discussion of that litigation is accordingly limited to those matters which bear upon the questions now before us.

relevant event for tax purposes and the use of the stock rights as a mechanism to accomplish that distribution should be disregarded. The court further held that the requirement of cash consideration to participate in the stock distribution did not violate the statutory directive that the distributing corporation distribute the stock of its subsidiary "with respect to its stock."[9] The Ninth Circuit, however, in *Commissioner v. Baan*, 382 F.2d 485 (9th Cir. 1967), reversed our decision as to the transaction's meeting the section 355(a)(1)(A) test. It found, in accordance with the Commissioner's argument, that the stock rights issued to the taxpayer were not "stock or securities" and, accordingly, the distribution of those rights could not qualify for nonrecognition treatment under section 355. But that did not dispose of the issue. The court assumed, without deciding, that the use of a stock rights scheme, standing alone, would not prevent the transfer of Northwest stock from Pacific to its shareholders from constituting a distribution "with respect to its stock." The fatal flaw, in that court's view, was the requirement of a $16 payment for each Northwest share; it held that that payment converted the stock distribution into a sale of corporate assets, and that a sale is not within the phrase "distributes * * * with respect to its stock."

The cases were reconsolidated on certiorari to the Supreme Court, where, as to the applicability of section 355, the judgment of the Ninth Circuit was affirmed and the judgment of the Second Circuit was reversed. *Commissioner v. Gordon*, 391 U.S. 83 (1968). The basis for decision was, however, an issue raised for the first time in

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[9] Judge Friendly, in dissent, found it unnecessary to reach the sec. 355(a)(1)(A) issue, but suggested that the Northwest stock was distributed "with respect to" the rights rather than the Pacific stock.

the Courts of Appeals. The Supreme Court did not reach the issues now before us.[10]

Petitioners urge that under the Court policy announced in *Golsen v. Commissioner*, 54 T.C. 742 (1970), *affd.* 445 F.2d 985 (10th Cir. 1971), *cert. denied* 404 U.S. 940 (1971), we are bound to our holding in the initial *Baan* case because it was affirmed on the current issues in the Second Circuit, and the Court of Appeals for the Seventh Circuit, to which an appeal in this case would normally lie, has not been confronted with the issues. For precisely the reason that the Seventh Circuit has not ruled on the issues, however, that policy is inapplicable. *Hughes v. Commissioner*, 65 T.C. 566, 569 (1975). Nevertheless, absent some indication of the need for self-correction, the policy of *stare decisis* operates in petitioners' favor. *Helvering v. Hallock*, 309 U.S. 106 (1940).

Respondent does not argue that the facts in *Baan*, as pertinent to the questions before us here, are distinguishable from the facts in this case, nor do we find them to be so. In both cases the taxpayer-petitioners, as shareholders in a distributing corporation, received from that corporation transferable short-term rights to acquire stock in a controlled subsidiary for less than its fair market value. Upon exercise of the rights so received and payment of the necessary cash consideration, each taxpayer received stock in the controlled subsidiary. Respondent does argue,

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[10] The Supreme Court's holding was extremely narrow. It held that the subpar. (D) requirement that the controlling corporation distribute all of its stock and securities in, or 80-percent control of, the controlled corporation was not satisifed by an initial distribution of less than the requisite amount in the absence of a binding commitment to make further distribution. Following the Supreme Court's decision, the cases were remanded to this Court to consider alternative contentions advanced by the taxpayers but not considered when the cases were first here. *Baan v. Commissioner*, 51 T.C. 1032 (1969), *affd. sub nom. Gordon v. Commissioner*, 424 F.2d 378 (2d Cir. 1970); *Baan v. Commissioner*, 450 F.2d 198 (9th Cir. 1971).

however, that the precedential value of our opinion in *Baan* has been eroded by its subsequent judicial history.

Respondent submits that the Supreme Court set forth the guiding principle for proper application of section 355 to the facts of this case in *Commissioner v. Gordon*, 391 U.S. at 91-92, where, with reference to section 355, it said: "The requirements of the section are detailed and specific, and must be applied with precision." The underlying rationale of respondent's position is that a stock rights scheme by its very nature offends the detailed and specific requirements of section 355. He pursues his position on two levels: (1) The interjection of stock rights prevents compliance with the literal terms of section 355(a)(1)(A), and (2) Congress did not intend to allow the use of stock rights in a transaction qualifying under section 355. The arguments presented on these points are not, however, mutually exclusive; each of the reasons respondent asserts that section 355(a)(1)(A) is offended in this case would, if correct, effectively prohibit the use of stock rights as a mechanism in a section 355 transaction. Respondent further submits that the rights distribution had "independent legal significance," thus making step transaction analysis inappropriate since there was no guarantee made when the rights were distributed that subscription for over 80 percent of the Shorewood stock would occur.

Respondent is mistaken in his treatment of this case. First, the applicability of our decision in the *Baan* case to the facts of this case has in no way been reduced by any decision in the extensive litigation of *Baan*. The Second Circuit affirmed; the Ninth Circuit reversed. These cases are merely persuasive authority in this instance, since an appeal in this case would normally lie in the Seventh Circuit. While the authority of the Supreme Court could have prevented the use of our decision in *Baan*, it does not do so here. Deciding to affirm our reversal by the Ninth Circuit on an issue not before us in *Baan*, nor before us here, the Supreme Court *did not reach or decide the issues in the*

instant case.[11] Therefore, our decision in *Baan* and the principles announced therein are applicable here. Further, the Supreme Court's call for "precision" application of section 355 does not mean that we must interpret the lack of specific provisions for the use of stock rights in a corporate separation under section 355 as legislative disapproval of such a mechanism.

We must also disagree with respondent's analysis of the significance of the rights distribution. It must be remembered that whether the step transaction doctrine applies determines whether a particular step has independent legal significance, not vice versa. Although it is true that a failure to distribute 80 percent or more of Shorewood's stock on February 2, 1971, or a failure to fulfill any other statutory requirement would have made petitioners ineligible for section 355 treatment,[12] we still decide tax consequences, however, on the basis of what has taken place, not what might have occurred. *Central Tablet Manufacturing Co. v. United States*, 417 U.S. 673, 690 (1974); *Commissioner v. National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 148-149 (1974). That different tax consequences would ensue if section 355 were inapplicable to the transaction for other reasons hardly provides a basis for resolving whether the stock rights scheme offends the statute. Further, the tax consequences of a rights distribution which is not an integral part of a corporate separation qualifying under section 355, whatever they may be (compare *Commissioner v. Gordon*, 391 U.S. at 98, with Rev. Rul. 70-521, 1970-2 C.B. 72), are not controlling here. Cf. *Sage v. Commissioner*, 83 F.2d 221

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[11] See n. 10 *supra*. In the instant case, distribution of over 80 percent of Shorewood stock occurred in a single transaction of approximately 1 month.

[12] This statement is framed to respond to the argument on the facts of this case and should not be taken as expressing any opinion on the validity of multistep divestitures under section 355.

(2d Cir. 1936) (what would otherwise have been a taxable dividend was not taxable because it was merely a step in a plan of reorganization).

As a general matter, a series of related steps designed and executed as part of a unitary plan to achieve a particular result is to be viewed as a whole, whether the effect of so doing is relief from or imposition of tax, where the substance of the transaction is comprehended within a pertinent revenue statute. *Kuper v. Commissioner*, 533 F.2d 152, 155-156 (5th Cir. 1976); *King Enterprises, Inc. v. United States*, 418 F.2d 511, 516-517 (Ct. Cl. 1969). Cf. *Atlee v. Commissioner*, 67 T.C. 395 (1976) (viewed as an integrated whole, several steps failed to meet the requirements of section 355).

Respondent correctly points out that there was no binding commitment for a stock distribution to follow the rights issuance. However, as well stated by the Court of Claims in *King Enterprises, Inc. v. United States, supra* at 518, the requirement by the Supreme Court in *Gordon* of a binding commitment was pronounced in a limited context and should be interpreted in the same limited manner. Application of that requirement to all other situations would practically eliminate the step transaction doctrine. That requirement will not be applied to this case.

The issuance of the rights by Water Co. was merely a procedural device to give Water Co. shareholders the opportunity to be included or excluded from the Shorewood stock distribution by their own decision. These rights existed only for a short period of time and only for this very limited purpose. Thus, their distribution was merely a brief transitory phase of the corporate separation. See *Helvering v. Alabama Asphaltic Limestone Co.*, 315 U.S. 179 (1942). Inclusion of this step in the overall stock distribution plan by Water Co. has in no way offended the purpose of section 355. Under the facts of this case, manipulation of the instant situation for tax avoidance purposes cannot be found to have existed. On the contrary,

petitioners readily admit, as they must, given the facts, that the distribution of Shorewood stock would have been taxable if not for compliance with section 355.[13]

As a result of the completed transaction (once petitioners had exercised their rights), petitioners held only Shorewood stock. They were given nothing else. Further, as the Supreme Court has found, the payment of cash in the exercise of those rights would not prevent the transaction from being a distribution.[14] Accordingly, we find that a distribution of Shorewood stock alone resulted from the transaction examined here.

Finally, we find that the stock distribution to petitioners was made "with respect to Water Co. stock" and thus satisfies the remaining element of subparagraph (A). It is inconsequential to the determination of this question that other shareholders may have elected out of the stock distribution by selling or otherwise failing to exercise their rights and that other distributees may not have received Shorewood stock in a shareholder capacity. Cf. Rev. Rul. 68-21, 1968-1 C.B. 104 (portfolio stock was offered on a pro rata basis to shareholders of X corporation in partial redemption of their X corporation stock; shareholders owning 35 percent of X stock availed themselves of the offer; distribution was made by reason of the corporation-shareholder relationship). It cannot be denied that

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[13] The Supreme Court agreed with this conclusion when, facing a similar problem, it said:

"Whether the actual dividend occurs at the moment when valuable rights are distributed or at the moment when their value is realized through sale or exercise, it is clear that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316. Such a sale thus results in a dividend to shareholders *unless some specific exception or qualification applies.* [*Commissioner v. Gordon*, 391 U.S 83, 89-90 (1968); fn. ref. omitted, emphasis supplied.]"

[14] See n. 13 *supra; Palmer v. Commissioner*, 302 U.S. 63, 69 (1937).

petitioners' status as Water Co. shareholders had some bearing upon their receipt of Shorewood stock. They were a part of that group which exercised rights in sufficient numbers to satisfy subparagraph (D). Viewing the process as a single transaction, we will not penalize petitioners because of their fleeting status as warrant holders during the swift implementation of that transaction.

In light of the discussion above, we will adhere to our conclusion in *Baan* that petitioners' receipt of the stock rights as an integral part of the transaction does not offend the provisions of section 355. We find nothing in the complex judicial history of the *Baan* litigation, aside from the Ninth Circuit, which would indicate any need for self-correction on these issues.

It is not questioned that Water Co. distributed stock rights to petitioners on January 7, 1971, with a view toward as it subsequently did, divesting itself of over 80 percent of Shorewood's stock on February 2, 1971. The rights were of use only for particiaption in the February 2, distribution. At the completion of the transaction, the only property petitioners held as a result of their participation was Shorewood stock. To the extent they acquired that stock for less than adequate consideration, they did so by reason of their status as Water Co. shareholders. The device clause and active business requirements of the statute were admittedly satisfied. There was a business purpose for both the corporate separation and the particular method by which it was carried out. Under these circumstances, we think the rights distribution is properly ignored in determining petitioners' tax consequences from the transaction. We decline respondent's invitation to equate the absence of statutory language in section 355 specifically authorizing the use of stock rights as a mechanism in a corporate separation with congressional disapproval of such action.

Our holding of course goes no further than the facts of this case. Cf. *Kansas Sand & Concrete, Inc. v. Commissioner*, 56

T.C. 522, 530 (1971), *aff'd.* 462 F.2d 805 (10th Cir. 1972). No Water Co. shareholders who sold their rights or who exercised rights acquired in the market are before us. Likewise, we find it unnecessary to consider the validity of Rev. Rul. 70-521, 1970-2 C.B. 72. We conclude only that based upon the record before us the distribution of Shorewood stock to petitioners, pursuant to their exercise of stock subscription rights issued to them as an integral part of the ultimate stock distribution, complies with the terms of section 355 as written and intended.

Decisions will be entered for the petitioners.

Reviewed by the Court.
DRENNEN, *J.*, did not participate in the disposition of the case.

STERRETT, *J.*, dissenting: In my view, the majority misconceives the reality of the transaction in issue.

The admitted goals to be accomplished by the transaction at issue were (1) at the instigation of the Indiana Public Service Commission, the divestiture of Shorewood by Water Co. and (2) the raising of additional capital for Shorewood.

To disgorge itself of subchapter C control (80 percent) of Shorewood and at the same time raise funds for its former subsidiary, Water Co. adopted a rather simple plan. It agreed to buy additional shares (855,630) from Shorewood contingent on the offering of these shares, plus a portion (213,907 out of 481,291) of the shares it already owned in Shorewood, to the holders of warrants which it intended to distribute with respect to its stock, on the basis of two warrants plus $5 for each share of Shorewood. Thus Shorewood could anticipate receiving in excess of $4 million in additional capital, Water Co. would have distributed 80 percent plus *1* share of Shorewood's outstanding stock, and received $1 million in fresh capital.

A perfectly reasonable means of accomplishing the two disparate corporate goals, but simply not within either the literal or spiritual ambit of section 355.

We must note at the outset that the Supreme Court in *Commissioner v. Gordon*, 391 U.S 83, 91-94 (1968), has instructed us to construe section 355 narrowly:

> Section 355 provides that certain distributions of securities of corporations controlled by the distributing corporation do not result in recognized gain or loss to the distributee shareholders. The requirements of the section are detailed and specific, and must be applied with precision * * *. Congress has abundant power to provide that a corporation wishing to spin off a *subsidiary must, however bona fide its intentions, conform the details of a distribution to a particular set of rules.* [Emphasis added.]

In the instant case, the petitioners received property in the form of warrants with respect to their Water Co. stock that had independent value since the warrants entitled them to a bargain purchase of Shorewood stock. Normally, this would constitute a distribution of property taxable as a dividend either at the time of receipt or at the time of sale or exercise. *Palmer v. Commissioner*, 302 U.S. 63 (1937).

Petitioners seek to avoid this result by applying the step or integrated transaction theory to couple the warrant distribution with the subsequent exchange of two warrants and $5 for 1 share of Shorewood stock. Petitioners' argument can fairly be paraphrased in terms that they contend that, since the warrants were distributed with respect to the Water Co. stock and since the use of the warrants to obtain Shorewood stock was an integral part of the warrant distribution plan, Shorewood stock then must also have been distributed with respect to Water Co. stock.

I cannot accept petitioners' rationale. I believe that the stock warrant issuance herein must be given independent significance and cannot simply be ignored because accompanied by an apparent spin off. Further, I believe

that, even if the rights issuance does not totally contaminate the purported section 355 divisive reorganization, the transaction before us still fails to qualify under section 355 because it has not been shown that the requisite control w s distributed.

I must comment here that, while the majority attempts to limit the effects of its opinion by assuring us that it "goes no further than the facts of this case," *Redding v. Commissioner*, 71 T.C. 597 (1979), the principles announced by the majority are not so limitable. They will apply equally to, and will affect the tax treatment of, all the shareholders of both Water Co. and Shorewood. It is irrelevant that petitioners sold none of their rights, exercised all of them, and received stock therefor (with the additional consideration of $5 cash per Shorewood share). Rather, our treatment of petitioners should depend on the substance of the transaction as a whole.

The majority finds that the "issuance of the rights by Water Co. was merely a procedural device to give Water Co. shareholders the opportunity to be included or excluded from the Shorewood stock distribution by their own decision." *Redding v. Commissioner, supra* at 612. But the rights issuance was much more than a mere "procedural device," it was the method through which Water Co. intended to obtain the capital funding for Shorewood (and possibly itself) which was one of the primary purposes behind the whole transaction. Further, the very words quoted above indicate that the rights issuance was much more than a mere procedural device to all the shareholders of Water Co. at the time of the issuance. For these shareholders, the rights issuance was a turning point—they could chose to pay $5 per Shorewood share and keep what they already owned, or could almost certainly sell the rights at a profit and lose their ownership interest in Shorewood, thereby surrendering the opportunity of buying Shorewood stock at a bargain. The shareholders could sell the rights only because they were valuable

property interests and because, as Water Co. had "expected" and planned for, they were traded over the counter.

Indeed, Shorewood stated in the prospectus dated January 7, 1971, issued with respect to the warrant distribution, that it "expected" that such trading would occur. Water Co. and Shorewood arranged for a "subscription agent" to be available to Water Co.'s warrant holders (regardless of whether they were shareholders) to facilitate the sale and exchange of these rights. It is clear, therefore, that Water Co. anticipated that some, perhaps many, of its shareholders would for one reason or another choose not to exercise the rights issued to them and wanted to facilitate the transfer of these rights into the hands of persons who would exercise them. Thus, the use of transferable stock rights was one of the primary methods Water Co. used to attract new capital to the entire Shorewood/Water Co. corporate enterprise.

When we think of an integrated transaction, we think of steps bound together, perhaps legally so, with no uncertainty from one step to the next. Here there was no absolute requirement that the shareholders exercise the warrants. Admittedly, the warrants were freely transferable and entitled the holder to a bargain purchase of Shorewood stock. Hence the probabilities were, from a practical point of view, that the warrants would be either exercised or sold. Nonetheless, to get Shorewood stock required an affirmative act on the part of each warrant holder which he was under no compulsion to take.

Thus, I object to the majority's conclusion that the rights issuance was of no independent significance. The transfer by Water Co. of Shorewood stock to Water Co. warrant holders was clearly conditioned on the payment of the $5 cash consideration per share. This was the transfer of property in consideration for the payment of money. In the *Baan* case on remand, *Baan v. Commissioner*, 51 T.C. 1032, 1037 (1969), *aff'd.* 450 F.2d 198 (9th Cir. 1971), *aff'd. sub*

nom. Gordon v. Commissioner, 424 F.2d 378 (2d Cir. 1970), this Court found an almost identical transaction to be a "sale." Given the majority's restrictive view of the impact and import of the Supreme Court decision in *Commissioner v. Gordon, supra* at 83, this was not a holding requirement by that opinion and can only be interpreted as a shift in position by this Court.[1]

Even if there was a "distribution" of stock within the meaning of section 355, and a further consequence of the issuance of warrants, it was not solely of Shorewood stock with respect to Water Co. stock. See sec. 355(a)(1). It is clear that Water Co.'s plan did not call for the distribution of stock to shareholders— and that the "distribution" of stock that did occur was not in respect of any stock in Water Co. The prerequisite to obtaining Shorewood stock was not the status of a Water Co. shareholder, but rather the status of a holder of warrants which may, or may not, have been obtained by reason of Water Co. stock ownership. See *Commissioner v. Gordon*, 382 F.2d 499, 513 (2d Cir. 1967) (Judge Friendly's dissenting opinion). Indeed, while it is not certain from the record, it is certainly probable that many of the warrants sold over the counter went into nonshareholder hands.[2] How can it be claimed that the exchange, between Water Co. and a nonshareholder third party, of Shorewood shares in return for $5 and two warrants was "actually" a distribution to a distributing corporation shareholder with respect to his stock?

A second point: Even assuming that an integrated transaction took place, petitioners still fail to meet the narrow requirements of section 355. Section 355(a)(1)(A)

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[1] If the transaction is viewed as the issuance by Shorewood of its stock through the medium of Water Co. acting as a conduit, then only this sale of the 213,907 Shorewood shares already owned by Water Co. could produce gain. Sec. 1032.

[2] Under any circumstance, it was the petitioners' burden to prove that the probability did not occur. This they did not do.

requires, in relevant part, that only stock of a controlled corporation may be distributed to the shareholders of the distributing corporation with respect to their stock in the distributing corporation. This may be thought of as the "to whom" of the distribution requirement. Section 355(a)(1)(D) describes what has to be distributed. That subparagraph requires that, at a minimum, stock constituting "control" of the controlled corporation within the meaning of section 368(c) must be distributed to shareholders of the distributing corporation. I do not believe that, on this record, we know to whom "control" was "distributed." Of the 1,336,921 shares of Shorewood issued and oustanding after the transaction under consideration, Water Co. retained 267,384 shares or exactly 20 percent, less 1 share, of the total. It must, therefore, have distributed a shade more than 80 percent, as is found by the majority. But the statute, when "applied with precision" (*Commissioner v. Gordon*, 391 U.S. at 92-93), does not merely require a "distribution"—it requires distribution of "control." Beyond that, it requires distribution of control to *shareholders of the distributing corporation.* Section 355 (a)(1)(A) and (D). But apparently there was no distribution of "control" to anyone herein, let alone Water Co.'s shareholders, because "control" was presumably destroyed by the transfer itself.

The majority found that Water Co. kept 267,384 shares of Shorewood common. It also found that "shareholders or their transferees or assignees subscribed to all 1,069,537 Shorewood shares offered, *except* for 50,000 shares acquired by the underwriters." (Emphasis added). *Redding v. Commissioner, supra* at 600. The clear import of the language is that *at most*, assuming that all the warrant transferees were also shareholders, 1,069,537 less 50,000 shares, or 1,019,537 shares, were acquired by Water Co. shareholders. This is approximately 76.26 percent of all the Shorewood shares issued and is not "control" within the meaning of section 368(c). In order to sustain the Court's decision herein one would have not only to ignore the

substance and importance of the rights issuance, but also assume that all the rights traded over the counter and all the underwriters were also Water Co. shareholders. I cannot join in this assumption and it seems, in any event, to be contrary to the above-quoted language. The petitioner has not shown to whom Water Co. transferred "control" inasmuch as no one related group of distributees had 80 percent of Shorewood's stock immediately after the transfer. It is not this Court's function to assume petitioner's *prima facie* case. Rather, such case must be proven.

To summarize, I do not believe that two legally freestanding steps can be run together and I am of the opinion that the realities are that the Shorewood stock was distributed with respect to warrants and not with respect to stock of Water Co. Hence the provisions of section 355(a)(1)(A) are not met. Furthermore, and in part for the same reason, I am unable to conclude from the record herein that Water Co. distributed, with respect to its stock, 80 percent of Shorewood to its shareholders in conformance with the requirements of section 355(a)(1)(A) and (D).

Appendix C

United States Court of Appeals

For the Seventh Circuit
Chicago, Illinois 60604
August 25, 1980

Before

Hon. WILLIAM J. BAUER, Circuit Judge
Hon. HARLINGTON WOOD, JR., Circuit Judge
Hon. RICHARD D. CUDAHY, Circuit Judge

GERALD R. REDDING and DOROTHY M. REDDING and THOMAS W. MOSES and ANNE M. MOSES, Petitioners-Appellees,	)	
No. 79-1775 & 79-1776	)	Appeals from the
vs.	)	Decisions of the
COMMISSIONER OF INTERNAL REVENUE, Respondent-Appellant.	)	United States Tax Court

This cause was heard on the record from the United States Tax Court, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this Court that the judgment of the said United States Tax Court in this cause appealed from be, and the same is hereby, REVERSED, with costs, and REMANDED, in accordance with the opinion of this Court filed this date.

Appendix D

SEC. 355 DISTRIBUTION OF STOCK AND SECURITIES OF A CONTROLLED CORPORATION.

(a) EFFECT ON DISTRIBUTEES.—

(1) GENERAL RULE.—If—

(A) a corporation (referred to in this section as the "distributing corporation")

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities,

solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution.

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing corporation or the controlled corporation or both (but the mere fact that subsequent to the distribution stock or securities in one or more of such corporations are sold or exchanged by all or some of the distributees (other than pursuant to an arrangement negotiated or agreed upon prior to such distribution) shall not be construed to mean that the transaction was used principally as such a device),

(C) the requirements of subsection (b) (relating to active businesses) are satisfied, and

(D) as part of the distribution, the distributing corporation distributes—

(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368(c), and it is established to the satisfaction of the Secretary that the retention

by the distributing corporation of stock (or stock and securities) in the controlled corporation was not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax,

then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) NON PRO RATA DISTRIBUTIONS, ETC.—Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all the shareholders of the distributing corporation.

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of section 368(a)(1)(D)).

(3) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (1)(D) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by the distributing corporation by reason of any transaction which occurs within 5 years of the distribution of such stock and in which gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) CROSS REFERENCE.—

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) REQUIREMENTS AS TO ACTIVE BUSINESS.—

(1) IN GENERAL.—Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) DEFINITION.—For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the time of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

Appendix E

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

THOMAS W. MOSES AND ANNE M. MOSES,	)	
Petitioners,	)	
v.	)	Docket No. 5176-75
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed January 22, 1979, it is

ORDERED AND DECIDED: That there is no deficiency in Federal income tax due from the petitioners for the calendar year 1971.

Entered January 23, 1979

(signed) J. Gregory Bruce
Judge

UNITED STATES TAX COURT
WASHINGTON, D.C. 20217

GERALD R. REDDING and DOROTHY M. REDDING,	)	
Petitioners,	)	
v.	)	Docket No. 5174-75.
COMMISSIONER OF INTERNAL REVENUE,	)	
Respondent.	)	

DECISION

Pursuant to the determination of the Court, as set forth in its Opinion filed January 22, 1979, it is

ORDERED AND DECIDED; That there is no deficiency in Federal income tax due from the petitioners for the calendar year 1971.

Entered January 23, 1979

(signed) J. Gregory Bruce
Judge

Supreme Court, U.S.
FILED
JAN 8 1981
MICHAEL RODAK, JR., CLERK

No. 80-818

In the Supreme Court of the United States

OCTOBER TERM, 1980

GERALD R. REDDING, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

WADE H. MCCREE, JR.
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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In the Supreme Court of the United States

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GERALD R. REDDING, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

Petitioners seek review of the decision below in this federal income tax case holding that they received a taxable dividend, when the Indianapolis Water Company distributed marketable warrants to them entitling them to buy stock of a subsidiary corporation (Shorewood) at less than the full fair market value of the Shorewood stock.

The pertinent facts are undisputed and may be summarized as follows: Shorewood Corporation, which was engaged in real estate development, was a wholly-owned subsidiary of the Indianapolis Water Company. The Indiana Public Service Commission took the position that real estate development was not an appropriate activity for a public utility such as the Water Company (Pet. App. A-2 to A-3). As a result, the Water Company's directors decided to

"spin-off" Shorewood, and further contemplated to increase Shorewood's capital at the same time. To this end, it was decided that Water Company shareholders would receive transferable warrants entitling them to purchase Shorewood stock at a bargain price of $5.00 per share plus two warrants. During the subscription period, Shorewood stock ranged in value from $5.70 to $7.00 per share (Pet. App. A-3, A-36). The warrants, which had to be exercised within a 15-day period, were actively traded, at prices ranging from 39 cents to $1.06 (Pet. App. A-3 to A-4, A-35). Water Company shareholders who did not want to put additional capital into Shorewood could sell their warrants to others, including non-shareholders, who were willing to put up additional capital (Pet. App. A-3 to A-4).

Petitioners were substantial shareholders of the Water Company and exercised all their warrrants to purchase Shorewood stock. They maintained that the distribution of warrants should be treated as merely a transitory step in a tax-free "spin-off," within the meaning of Section 355 of the Internal Revenue Code of 1954 (26 U.S.C.), which requires, *inter alia*, that the distributing corporation distribute stock or securities of the controlled corporation in an amount sufficient to constitute "control," which is defined in Section 368(c) to mean 80% of the voting stock (Pet. App. A-4 to A-5).[1] On audit, the Commissioner contended that the distribution of warrants should be treated as an independent taxable event, and not as a distribution of stock or

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[1]The amount of Shorewood stock to be sold to warrant holders was 1,069,537 shares, or 80% plus one share. Although the Commissioner stipulated (see Supp. App. A, at 10 to appellee's brief in the court of appeals) that, "[t]he 1,069,537 shares of Shorewood stock that were distributed on the Date of Distribution by the Water Company constituted more than 80% of the total number of shares of the only class of outstanding shares of Shorewood stock, and represented control of Shorewood, as defined in *Int. Rev. Code of 1954*, § 368(c)," some 50,000 of those shares were distributed to underwriters rather than to Water Company shareholders (Pet. App. A-20). Thus, although the language of the stipulation is concededly ambiguous, it seems clear that the

securities under Section 355.[2] In this suit brought by petitioners for redetermination of the ensuing deficiences, the Tax Court held that the transaction qualified as a tax-free spin-off under Section 355 (Pet. App. A-31 to A-57). The court of appeals reversed (Pet. App. A-1 to A-29). In upholding the Commissioner's position, the court emphasized that the use of the warrants was intended to permit Water Company stockholders to opt *out* of the purchase of Shorewood stock, rather than to be included *in* the Shorewood purchase, while raising cash for Shorewood's operations (Pet. App. A-11, A-12).

1. The decision below correctly held that the transaction did not qualify for tax-free treatment under Section 355. In substance, those shareholders who sold their warrants received an immediate cash benefit in return for giving up their interest in Shorewood, while Shorewood received the additional capital it needed when the warrant holders purchased stock. Thus, far from constituting a mere "procedural device" to facilitate distribution of Shorewood stock to

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transaction at issue failed to comply with the requirements of Section 355(a)(1)(D), because the percentage of the stock distributed to the Water Company shareholders amounted to, at most, 76.26% of all Shorewood shares (Pet. App. A-20). However, the court of appeals declined to address this argument on the belief that it was foreclosed by the stipulation (see Pet. App. A-20 to A-21).

[2]Treasury Regulations on Income Tax, Section 1.355-1(a) (26 C.F.R.) provides that stock warrants are not "stock or securities" for purposes of Section 355. Petitioners at no point have challenged the validity of this regulation. Rather, petitioners' case is premised on treating the warrants as an insubstantial intermediate step leading to the eventual distribution of Shorewood shares.

Water Company shareholders, the distribution of warrants conferred an independent economic benefit, and permitted Water Company shareholders to elect to take an immediate cash payment in lieu of exercising their warrants (Pet. App. A-11). In these circumstances, the court of appeals properly refused to characterize the arrangement as a "step transaction" so as to combine the warrant distribution with the purchase of Shorewood stock (Pet. App. A-11 to A-12). Instead, it ruled that Section 355 did not apply because the distribution of warrants was not a distribution of "solely stock or securities," and because the sale of the Shorewood stock to warrant holders was not a distribution with respect to Shorewood stock, as required by Section 355(a)(1)(A) (Pet. App. A-9 to A-12, A-17).

2. Contrary to petitioners' argument (Pet. 5-8), the decision below does not conflict with either *Commissioner* v. *Gordon*, 382 F. 2d 499 (2d Cir. 1967), rev'd, 391 U.S. 83 (1968), or *Palmer* v. *Commissioner*, 302 U.S. 63 (1937). *Gordon* arose out of an attempt to bring a spin-off within Section 355 where the distribution to shareholders was made in more than one step. There, as here, a corporation distributed short-term transferable stock rights to its shareholders, followed by a sale of stock at a bargain price, pursuant to the terms of the rights. The offering was made in two stages, the first in 1961 of 57.3% of the stock of the controlled corporation, and the balance in 1963. The Tax Court originally held that Section 355 was applicable, and the exercise of the rights was not a taxable event to the recipients (45 T.C. 71) (1965). On the Commissioner's appeals to both the Second and Ninth Circuits, the Second Circuit affirmed (382 F. 2d at 509), ruling that Section 355 does not require a one-step distribution and that the two distributions of warrants, followed each time by a sale of stock pursuant to the warrants, extending over a total of three years, satisfied Section 355 and were tax free. The Ninth Circuit disagreed, ruling (*Commissioner* v. *Baan*, 382 F. 2d 485, 496 (1967), aff'd, 391 U.S. 83 (1968)) that the

bargain sale of stock to the rights holders was not a "distribution" as that term is used in Section 355, that Section 355 required the transfer of control in a single "transaction" if not in a single step, and that these requirements had not been satisfied. In *Commissioner* v. *Gordon*, 391 U.S. 83 (1968), this Court resolved the conflict and upheld the Commissioner's position that the two distributions of rights, occurring over three years and without a binding commitment at the time of the first distribution as to when or if the second distribution would take place, could not be aggregated for purposes of meeting the "control" requirement (*id.* at 96).

Petitioners do not point to any specific respect in which the analysis of the court below conflicts with the analysis of the Second Circuit's *Gordon* opinion. At all events, since that decision was reversed by this Court, it can hardly be invoked as a precedent conflicting with the court below.

Nor does the decision below conflict with *Palmer* v. *Commissioner*, *supra*. In *Palmer*, the Court held that the mere issuance by a corporation to its shareholders of rights to subscribe for stock in another corporation was not a dividend until the sale or exercise of such rights. In *Commissioner* v. *Gordon*, *supra*, 391 U.S. at 89-90 n.4, the Court addressed *Palmer*, noting that, "[i]t has not, however, been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or the dividend occurs only on the actual purchase. In the present case this need not be decided." This case involves such an issuance of rights (warrants) to purchase stock at less than fair market value, *viz.*, the exact situation that this Court in *Gordon* said that *Palmer* did not cover. Moreover, the decision below is not only in harmony with the pertinent provisions of the Code,[3] but is in accord

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[3]Under Section 316(a) of the Internal Revenue Code of 1954 (26 U.S.C.), any distribution of property by a corporation to its shareholders, out of earnings and profits accumulated subsequent to March 1,

with *Baumer* v. *United States*, 580 F. 2d 863, 878-881 (5th Cir. 1978), and the views of numerous commentators.[4]

Finally, petitioners claim (Pet. 8-9) that the question presented has substantial administrative importance for tax planning. But this is only the second reported case we have been able to find involving a dispute as to the applicability of Section 355 to a multi-step "distribution." There is accordingly no basis for review by this Court.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

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1913, is a dividend. When property is distributed in kind to a non-corporate shareholder, the amount of the distribution is the fair market value of the property at the time of distribution (see Section 301(b)(1)(A) of the Internal Revenue Code of 1954 (26 U.S.C.)). "Property," as defined in Section 317(a) of the Code, "means money, securities, and any other property; except that such term does not include stock in the corporation making the distribution (or rights to acquire such stock)." This broad definition of property includes stock warrants (options or rights to purchase stock). Indeed, the specific exclusion of rights to acquire stock of the distributing company would indicate that rights to purchase stock in *other* corporations are included in the term "property." *Baumer* v. *United States*, 580 F. 2d 863, 881 (5th Cir. 1978).

[4]See, *e.g.*, Jassy, *Dividend Treatment of Distributions of Options to Acquire Assets of the Distributing Corporation*, 34 Tax L. Rev. 607, 633-638, 644-645 (1979); Smith, *Rights Offerings of Portfolio Securities*, 26 Tax Law., 471, 480-481, 483 (1973); Carlson, *Taxation of "Taxable" Stock Rights: The Strange Persistence of Palmer* v. *Commissioner*, 23 Tax L. Rev. 129, 131-132, 152-153 (1968); and Whiteside, *Income Tax Consequences of Distributions of Stock Rights to Shareholders*, 66 Yale L.J. 1016, 1024 (1957).